Tax Expenditures and Evaluations

2004

Canada

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Tax Expenditures and Evaluations

2004

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PREFACE

Since 2000 the tax expenditure report has been separated into two documents. This document, *Tax Expenditures and Evaluations*, is published on an annual basis. It provides estimates and projections for broadly defined tax expenditures as well as evaluations and descriptive papers addressing specific tax measures. Two presentational changes have been made this year. First, the estimates and projections are now grouped by functional category (e.g. small business) for business income tax and goods and services tax measures, as they have been for personal income tax measures. Second, subheadings have been added to the "Memorandum Items" section of the tables to identify various categories of measures that are part of the benchmark tax system (e.g. recognition of expenses incurred to earn income).

This year's edition of *Tax Expenditures and Evaluations* includes two studies. The first presents the results of an evaluation of the disability tax credit, which was undertaken further to the Government's response to the Seventh Report of the Standing Committee on Human Resources Development and the Status of Persons with Disabilities. The second study examines the long-run economic costs imposed by the principal taxes in Canada using a model of the Canadian economy developed at the Department of Finance.

The companion document, *Tax Expenditures: Notes to the Estimates/Projections*, is being published again this year. It is a reference document for readers who want information on the objectives of individual tax expenditures and who wish to know more about how the estimates and projections are calculated.

PART 1
TAX EXPENDITURES:
ESTIMATES AND PROJECTIONS

INTRODUCTION

The principal function of the tax system is to raise the revenues necessary to fund government expenditures. How much revenue is raised is determined by tax bases and tax rates. It is also a function of a range of measures—special tax rates, exemptions, deductions, rebates, deferrals and credits—that affect the level and distribution of tax. These measures are sometimes called "tax expenditures" because they have an impact on government revenue (i.e. they have a cost) and they reflect policy choices of the Government.

In order to define tax expenditures, it is necessary to establish a "benchmark" tax structure that applies the relevant tax rates to a broadly defined tax base—e.g. personal income, business income or consumption. Tax expenditures are then defined as deviations from this benchmark. Reasonable differences of opinion exist about what should be considered a normal part of the tax system and hence about what should be considered a tax expenditure. For example, a deduction for expenses incurred in earning income is generally considered as part of the benchmark and thus not as a tax expenditure. But in some cases the deduction may confer some personal benefit, making its classification ambiguous.

This report takes a broad approach and includes estimates and projections of the revenue loss associated with all but the most fundamental structural elements of the tax system, such as the progressive personal income tax rate structure. This includes not only measures that may reasonably be regarded as tax expenditures but also other measures that may be considered part of the benchmark tax system. The latter are listed separately under "Memorandum Items." For instance, the dividend tax credit is listed under this heading because its purpose is to reduce or eliminate the double taxation of income earned by corporations and distributed to individuals through dividends. Also included under this heading are measures for which there may be some debate over whether they should be considered tax expenditures or where data limitations do not permit a separation of the tax expenditure and benchmark components of the measure. This approach provides information on a full range of measures.

Caveats

Care must be taken in interpreting the estimates and projections of tax expenditures in the tables for the following reasons.

- The estimates and projections are intended to indicate the potential revenue gain that would be realized by removing individual tax measures. They are developed assuming that the underlying tax base would not be affected by removal of the measure. However, this is an assumption that is unlikely to be true in practice as the behaviour of economic agents, overall economic activity and other government policies could change along with the specific tax provision.
- The cost of each tax measure is determined separately, assuming that all other tax provisions remain unchanged. Many of the tax expenditures do, however, interact with each other such that the impact of several tax provisions at once cannot generally be calculated by adding up the estimates and projections for each provision.
- The federal and provincial income tax systems interact with each other to various degrees. As a result, changes to tax expenditures in the federal system may have consequences for provincial tax revenues. In this publication, however, any such provincial effects are not taken into account—that is, the tax expenditure estimates and projections address strictly the federal tax system and federal tax revenue.
- In the case of the harmonized sales tax in effect in Nova Scotia, New Brunswick, and Newfoundland and Labrador, only the federal cost of the tax expenditures is reported.
- The tax expenditure estimates and projections presented in this document are developed using the latest available taxation data. Revisions to the underlying data as well as improvements to the methodology can result in substantial changes to the value of a given tax expenditure in successive publications. In addition, estimates and projections for some tax measures, such as the half inclusion rate on capital gains, are particularly sensitive to economic parameters and hence may also differ significantly from one publication to the next.

WHAT'S NEW IN THE 2004 REPORT

A number of new tax measures have been introduced since last year's report and others have been modified. These are described below.

Personal Income Tax

Disability Supports Deduction

- Budget 2004 proposed to replace the attendant care deduction with a broader disability supports deduction, effective for the 2004 and subsequent taxation years. The deduction will recognize, in addition to attendant care, other disability supports expenses incurred for education or employment purposes (such as tutoring for persons with learning disabilities), unless they have been reimbursed by a non-taxable payment (e.g. insurance payment). Individuals will not have to be eligible for the disability tax credit in order to claim the deduction. The deduction will generally be limited to the lesser of the amounts paid for eligible expenses and the taxpayer's earned income, which includes wages, self-employment income and scholarships. Students may be able to deduct a higher amount.

Mineral Exploration Tax Credit

- In October 2000 the Government introduced a temporary tax credit for mineral exploration to moderate the impact of the global downturn in exploration activity. The credit provides individuals with an additional tax incentive related to the purchase of certain flow-through share investments. The credit is equal to 15 per cent of specified grass roots mineral exploration expenses incurred in Canada by a corporation and renounced to an individual under a flow-through share agreement.

  The 2003 budget announced an extension to the scheduled expiry date of the credit by one year to December 31, 2004. It also removed a restriction that had made the flow-through share look-back rule unavailable for the final year of the credit. As a result of the 2003 budget measure, funds raised from an individual under a flow-through share agreement in 2004 can be expended by a corporation up to the end of 2005 and be eligible for the credit as a deemed expense of the individual in 2004.

  Although market conditions for mineral exploration have improved since the credit was introduced, Budget 2004 proposed to establish in legislation an expiry date for the credit of December 31, 2005, in order to provide companies with ample time to plan their transition from the credit. Under the look-back rule, this will allow eligible expenses to be incurred up until the end of 2006.

Medical Expense Tax Credit

- Budget 2004 proposed changes to the medical expense tax credit to allow caregivers to claim more of the medical and disability-related expenses that they incur on behalf of dependent relatives.
  - Specifically, medical expense claims made on behalf of minor children will be pooled with the medical expenses of the taxpayer and his or her spouse or common-law partner, subject to the taxpayer's minimum expense threshold (for 2004, the lesser of 3 per cent of the taxpayer's net income and $1,813), without regard to the income of the minor child.
  - For medical expenses paid on behalf of other dependent relatives (e.g. grandparent, niece, nephew, etc.), taxpayers will be able to claim qualifying medical expenses paid on behalf of such a dependant that exceed the lesser of 3 per cent of the dependant's net income and $1,813 (that is, the threshold for the medical expense tax credit that would apply if the dependant claimed the expenses). The maximum eligible amount that can be claimed on behalf of dependent relatives other than minor children will be $5,000.

Tax Relief for Canadian Forces Personnel and Police

- The 2004 budget introduced tax relief for Canadian Forces personnel and police deployed to dangerous international operational missions. Eligible individuals will be entitled to deduct from their taxable income the amount of their related employment earnings from these missions to the extent that those earnings have been included in computing income, up to the maximum rate of pay earned by a non-commissioned member of the Canadian Forces (currently $6,089 per month). This measure applies to the 2004 and subsequent tax years.

Canada Learning Bond/Enhanced Canada Education Savings Grant

- To provide greater support for low-income Canadians to help offset the costs of post-secondary education, Budget 2004 proposed two measures to assist low- and middle-income families to save towards their children's future post-secondary education.
  - Budget 2004 introduced the Canada Learning Bond (CLB) program, designed to kick-start education savings for children in low-income families. The CLB will provide up to $2,000 of education savings in a registered education savings plan (RESP) by age 16 for children in families entitled to the National Child Benefit supplement.
  - The budget also proposed enhancements to the Canada Education Savings Grant (CESG) program to strengthen assistance for low- and middle-income families that wish to save for their children's post-secondary education using an RESP.
- While the CLB and CESG do not directly represent a tax expenditure, they increase the cost of the tax expenditure associated with RESPs to the extent that they encourage their increased use.

Business Income Tax

Accelerating the Increase in the Small Business Limit

- The 2003 budget provided that the amount of active business income eligible for the small business deduction would increase from $200,000 in 2002 to $225,000 for 2003, $250,000 for 2004, $275,000 for 2005 and $300,000 after 2005. The 2004 budget proposed to accelerate the implementation of the measure by increasing the eligible amount to $300,000 for 2005 and subsequent years.

Goods and Services Tax

Increased GST Rebate for Municipalities

- As announced in the February 2, 2004, Speech from the Throne, the rebate in respect of the goods and services tax and the federal portion of the harmonized sales tax for municipalities was increased to 100 per cent from 57.14 per cent. This measure has been legislated and is effective February 1, 2004.

THE TAX EXPENDITURES

Tables 1 to 3 provide tax expenditure values for personal income tax, corporate income tax and the goods and services tax (GST) for the years 1999 to 2006.

Estimates and projections are developed using the methodology set out in Chapter 1 of *Tax Expenditures: Notes to the Estimates/Projections*.[1] The economic variables used to develop the estimates and projections are based on the private sector average forecast presented in the March 2004 budget.

The tax expenditures are grouped according to functional categories. This grouping is provided solely for presentational purposes and is not intended to reflect underlying policy considerations.

All estimates and projections are reported in millions of dollars. The letter "S" indicates that the cost is less than $2.5 million, "n.a." signifies that data is not available to support a meaningful estimate/projection, and a dash means that the tax expenditure is not in effect. The inclusion in the report of items for which estimates and projections are not available is warranted given that the report is designed to provide information on measures included in the tax system even if it is not always possible to provide their revenue impacts. Work is continuing to obtain quantitative estimates and projections where possible.

[1] Available on the Department of Finance Web site at www.fin.gc.ca.

Table 1
Personal Income Tax Expenditures*†

	Estimates			Projections				
	1999	2000	2001	2002	2003	2004	2005	2006
	($ millions)							
Charities, Gifts and Contributions								
Charitable donations credit	1,350	1,495	1,490	1,515	1,550	1,575	1,605	1,635
Reduced inclusion rate for capital gains arising from donations of publicly listed securities and ecologically sensitive land[1]	13	19	6	6	7	8	9	10
Non-taxation of capital gains on gifts of cultural property[2]	11	14	10	9	11	12	13	13
Non-taxation of gifts and bequests	n.a.	n.a	n.a	n.a.	n.a.	n.a.	n.a.	n.a.
Political contribution tax credit[3]	10	19	8	9	9	22	18	21
Culture								
Assistance for artists	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Deduction for artists and musicians	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Education								
Adult basic education—tax deduction for tuition assistance	–	–	–	10	5	5	5	5
Apprentice vehicle mechanics' tools deduction	–	–	–	10	10	10	10	10
Education credit[4]	135	140	260	260	270	275	280	285
Tuition fee credit	290	310	275	285	305	315	325	335
Carry-forward of education and tuition fee credits	110	165	170	170	175	175	180	180
Transfer of education and tuition fee credits	335	325	390	400	415	430	440	445
Partial exemption of scholarship, fellowship and bursary income[5]	6	29	21	21	22	22	23	23
Registered education savings plans (RESPs)[6]	75	97	105	115	125	125	140	145
Student loan interest credit	58	66	66	67	70	71	73	75

*** The elimination of a tax expenditure would not necessarily yield the full tax revenues shown in the table. See the publication *Tax Expenditures: Notes to the Estimates/Projections*, available on the Department of Finance Web site at www.fin.gc.ca, for a discussion of the reasons for this.**

† The February 2000 budget fully indexed, effective January 1, 2000, those parameters that were previously only partially indexed. The *Economic Statement and Budget Update* of October 2000 reduced all personal income tax rates and eliminated the deficit reduction surtax, effective January 1, 2001. These rate reductions lower the value of exemptions and deductions, as well as those non-refundable tax credits whose values depend on a tax rate, in the year the change was introduced, but this is generally followed by growth in their value over time in line with increases in the underlying tax base.

Table 1
Personal Income Tax Expenditures *(cont'd)*

	Estimates			Projections				
	1999	2000	2001	2002	2003	2004	2005	2006
				($ millions)				
Employment								
Deduction for income earned by military and police deployed to high-risk international missions[7]	–	–	–	–	–	30	30	30
Deduction of home relocation loans	S	S	S	S	S	S	S	S
Deferral of salary through leave of absence/sabbatical plans	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Employee benefit plans	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Employee stock options[8]	295	690	650	520	500	500	500	500
Non-taxation of certain non-monetary employment benefits	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Non-taxation of strike pay	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Northern residents deductions	135	135	125	125	125	125	130	130
Overseas employment credit	53	55	57	58	59	60	60	61
Tax-free amount for emergency service volunteers	14	14	14	14	14	14	14	14
Family								
Canada Child Tax Benefit (CCTB)[9]	5,930	6,610	7,370	7,755	8,205	8,725	9,295	9,705
Caregiver credit[10]	29	35	57	60	60	65	65	70
Deferral of capital gains through transfers to a spouse, spousal trust or family trust	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Infirm dependant credit[10]	7	5	6	5	5	5	5	5
Spouse or common-law partner credit[11]	1,140	1,225	1,160	1,210	1,245	1,310	1,350	1,395
Eligible dependant credit[11]	545	625	610	630	645	665	680	695
Farming and Fishing								
$500,000 lifetime capital gains exemption for farm property[12]	355	325	215	220	220	220	225	225
Cash basis accounting	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Deferral of capital gains through intergenerational rollovers of family farms and commercial woodlots	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Deferral of income from destruction of livestock[13]	S	S	3	S	S	3	-3	S
Deferral of income from sale of livestock during drought years	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Deferral of income from grain sold through cash purchase tickets[14]	51	5	-26	21	-3	8	9	10

Table 1
Personal Income Tax Expenditures *(cont'd)*

	Estimates			Projections				
	1999	2000	2001	2002	2003	2004	2005	2006
	($ millions)							
Deferral through 10-year capital gain reserve	S	S	S	S	S	S	S	S
Exemption from making quarterly tax instalments	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Flexibility in inventory accounting	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Tax treatment of the Net Income Stabilization Account[15]								
Deferral of tax on government contributions	94	74	66	170	45	S	S	S
Deferral of tax on bonus and interest income	35	34	31	26	23	22	7	S
Taxable withdrawals	-100	-86	-76	-105	-100	-185	-160	-8
Federal-Provincial Financing Arrangements								
Logging tax credit	S	S	S	S	S	S	S	S
Quebec abatement	2,860	3,175	2,965	3,050	3,145	3,260	3,495	3,735
Transfer of income tax points to provinces	12,920	14,105	13,555	13,585	14,050	14,560	15,615	16,695
General Business and Investment								
$200 capital gains exemption on foreign exchange transactions	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
$1,000 capital gains exemption on personal-use property	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Deduction of accelerated capital cost allowance[16]	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Deferral through use of billed basis accounting by professionals	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Deferral through capital gains rollovers	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Deferral through five-year capital gain reserve[17]	45	64	20	21	21	21	22	22
Investment tax credits	28	28	33	33	33	33	33	33
Mineral exploration tax credit for flow-through share investors[18]	–	18	35	50	55	60	62	-16
Partial inclusion of capital gains[19]	1,035	2,500	1,985	2,030	2,080	2,115	2,160	2,205
Taxation of capital gains upon realization[20]	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Small Business								
$500,000 lifetime capital gains exemption for small business shares[21]	685	740	345	355	360	365	370	375
Deduction of allowable business investment losses	62	39	44	45	46	47	48	49
Deferral through 10-year capital gain reserve	S	S	S	S	S	S	S	S

Table 1
Personal Income Tax Expenditures *(cont'd)*

	Estimates			Projections				
	1999	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**
				($ millions)				
Labour-sponsored venture capital corporations credit[22]	180	255	215	190	155	155	155	155
Rollovers of investments in small businesses	–	3	6	10	20	25	30	30
Health								
Child Disability Benefit (CDB)[23]	–	–	–	–	25	50	50	50
Disability tax credit (DTC)[24]	265	275	330	345	365	375	390	405
Medical expense tax credit[25]	500	550	570	645	700	765	810	860
Non-taxation of business-paid health and dental benefits	1,735	1,610	1,710	1,870	2,080	2,240	2,445	2,640
Refundable medical expense supplement	36	42	55	60	65	70	70	75
Income Maintenance and Retirement								
Age credit	1,355	1,385	1,320	1,375	1,425	1,490	1,540	1,600
Deferred profit-sharing plans	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Non-taxation of certain amounts received as damages in respect of personal injury or death	17	15	15	15	16	15	16	16
Non-taxation of Guaranteed Income Supplement and Allowance benefits	275	290	265	275	290	295	300	310
Non-taxation of investment income on life insurance policies[26]	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Non-taxation of RCMP pensions/compensation in respect of injury, disability or death	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Non-taxation of social assistance benefits[27]	315	290	245	230	230	210	205	200
Non-taxation of up to $10,000 of death benefits	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Non-taxation of veterans' allowances, civilian war pensions and allowances, and other service pensions (including those from Allied countries)	S	S	S	S	S	S	S	S
Non-taxation of veterans' disability pensions and support for dependants	160	135	135	150	150	150	150	150
Non-taxation of workers' compensation benefits	635	665	650	685	725	745	785	825
Pension income credit	415	425	405	415	425	435	440	455

Table 1
Personal Income Tax Expenditures *(cont'd)*

	Estimates			Projections				
	1999	2000	2001	2002	2003	2004	2005	2006
				($ millions)				
Registered pension plans (RPPs)[28]								
Deduction for contributions	5,030	4,895	4,575	4,400	4,870	5,265	5,810	6,120
Non-taxation of investment income[29]	17,285	10,455	-810	415	7,950	8,155	9,415	9,720
Taxation of withdrawals	-6,695	-6,695	-6,415	-6,770	-7,235	-7,500	-7,960	-8,445
Net tax expenditure	15,620	8,655	-2,655	-1,950	5,590	5,920	7,265	7,390
Registered retirement savings plans (RRSPs)[28]								
Deduction for contributions	6,965	7,155	6,225	6,300	6,790	7,100	7,565	8,130
Non-taxation of investment income[29]	8,820	5,480	-435	235	4,770	5,105	6,130	6,570
Taxation of withdrawals	-2,665	-3,515	-3,465	-4,040	-4,410	-4,695	-5,105	-5,550
Net tax expenditure	13,120	9,120	2,320	2,500	7,150	7,515	8,585	9,155
Supplementary Information:								
Present value of tax assistance for retirement savings plans[30, 31]	8,245	8,100	7,265	7,180	7,780	8,265	8,910	9,465
Saskatchewan Pension Plan	S	S	S	S	S	S	S	S
Treatment of alimony and maintenance payments	170	170	115	115	110	105	105	105
Other Items								
Deduction related to vows of perpetual poverty	S	S	S	S	S	S	S	S
Deduction for clergy residence	63	68	67	69	70	70	71	72
Non-taxation of capital gains on principal residences[32]								
Partial inclusion rate	970	1,000	885	1,405	1,835	1,870	1,875	1,875
Full inclusion rate	1,295	1,530	1,770	2,810	3,665	3,740	3,745	3,745
Non-taxation of income from the Office of the Governor General	S	S	S	S	S	S	S	S
Non-taxation of income of Indians on reserves	n.a.	n.a	n.a	n.a.	n.a.	n.a.	n.a.	n.a.
Special tax computation for certain retroactive lump-sum payments	S	S	S	S	S	S	S	S

Table 1
Personal Income Tax Expenditures *(cont'd)*

	Estimates			Projections				
	1999	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**
				($ millions)				
Memorandum Items								
Avoidance of Double Taxation								
Dividend gross-up and credit	1,240	970	1,215	1,170	1,250	1,350	1,525	1,645
Foreign tax credit	535	585	635	645	655	660	670	680
Non-taxation of capital dividends	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Recognition of Expenses Incurred to Earn Income								
Child care expense deduction[33]	545	595	530	540	545	540	550	560
Deduction of carrying charges incurred to earn income	760	875	825	860	905	930	970	1,005
Deduction of union and professional dues	570	590	550	570	595	600	620	640
Disability supports deduction (attendant care deduction)[34]	S	S	S	S	S	15	15	15
Moving expense deduction	79	71	81	83	86	87	90	92
Loss Offset Provisions								
Capital loss carry-overs[35]	190	225	86	87	90	91	93	95
Farm and fishing loss carry-overs	12	14	16	15	15	15	14	14
Non-capital loss carry-overs	110	91	78	79	82	83	85	87
Social and Employment Insurance Programs								
Canada Pension Plan and Quebec Pension Plan[36]								
Employee-paid contribution credit	1,600	1,845	1,980	2,245	2,465	2,545	2,630	2,715
Non-taxation of employer-paid premiums[37]	2,515	2,845	2,980	3,385	3,730	3,785	3,920	4,055
Employment insurance								
Employment insurance contribution credit	1,230	1,200	1,085	1,085	1,060	1,020	1,045	1,065
Non-taxation of employer-paid premiums	2,585	2,485	2,160	2,160	2,120	2,000	2,050	2,095
Other								
Basic personal credit	19,610	21,065	20,460	21,310	21,985	22,935	23,650	24,395
Supplementary low-income credit[38]	135	–	–	–	–	–	–	–
Deduction of farm losses for part-time farmers	62	59	60	58	58	57	58	58
Deduction of other employment expenses	730	770	735	760	790	800	825	850
Deduction of resource-related expenditures	145	125	155	160	165	165	170	175
Reclassification of flow-through shares[39]	20	24	33	30	32	31	31	31

Table 1
Personal Income Tax Expenditures *(cont'd)*

	Estimates			Projections				
	1999	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**
				($ millions)				
Non-taxation of lottery and gambling winnings[40]	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Non-taxation of specified incidental expenses[41]	4	4	–	–	–	–	–	–
Non-taxation of allowances for diplomats, military and other government employees posted abroad	9	9	9	10	11	12	13	14
Partial deduction of meals and entertainment expenses	77	86	85	86	87	87	88	89

Notes:

1 The decline in the tax expenditure in 2001 reflects both the decline in capital markets after the year 2000 and the reduction in the normal capital gains inclusion rate from three-quarters to one-half in 2000.

The total tax expenditure cost to the Government of this measure has two components: the revenue forgone as a result of the reduced inclusion rate (which is shown in the main table) and the increased cost of the charitable donations credit from any increase in donations that result from the measure. If all donations of listed securities and ecologically sensitive land would have been made in the absence of this measure, then (as shown in the main table) the total cost ranges from $6 million to $19 million between 1999 and 2006. If, on the other hand, all donations of listed securities and ecologically sensitive land came about as a result of the reduced inclusion rate on capital gains, and if in the absence of the measure the shares and land would have been sold instead of donated, then the cost of the measure ranges from $42 million to $80 million between 1999 and 2006, as shown below (in millions of dollars):

1999	2000	2001	2002	2003	2004	2005	2006
52	80	42	45	53	61	68	77

The true costs fall somewhere between the lower and upper bounds set by the ranges indicated.

2 The tax expenditure after 1999 reflects the reduction in the normal capital gains inclusion rate from three-quarters to one-half in 2000.

The total tax expenditure cost to the Government of this measure has two components: the revenue forgone as a result of the reduced inclusion rate (which is shown in the main table) and the increased cost of the charitable donations credit from any increase in donations that result from the measure. If all donations of cultural property would have been made in the absence of this measure, then (as shown in the main table) the total cost ranges from $9 million to $14 million between 1999 and 2006. If, on the other hand, all donations of cultural property came about as a result of the reduced inclusion rate on capital on capital gains, and if in the absence of this measure the property would have been sold instead of donated, then the cost of the measure ranges from $38 million to $72 million between 1999 and 2006, as shown below (in millions of dollars):

1999	2000	2001	2002	2003	2004	2005	2006
38	50	52	49	61	66	68	72

The true costs fall somewhere between the lower and upper bounds set by the ranges indicated.

Table 1
Personal Income Tax Expenditures *(cont'd)*

[3] The increase in 2000 reflects two factors. First, starting in 2000, the first credit threshold was increased from $100 to $200. Second, there was a federal general election in 2000 and, as historical data show, the level of political contributions increases significantly during an election year. The projected increase in 2004 reflects three factors. First, starting in 2004, the three credit thresholds are increased by $200 each. Second, An Act to amend the Canada Elections Act and the Income Tax Act, which received Royal Assent on May 14, 2004, enables additional political parties to become registered and eligible for the tax credit. Finally, there was a federal general election in 2004.

[4] The October 2000 *Economic Statement and Budget Update* increased the education credit to $400 per month for full-time students and $120 per month for part-time students, effective January 1, 2001. The 2001 budget introduced a measure that extends the education credit, beginning in 2002, to people who receive taxable assistance for post-secondary education under certain government programs. Budget 2004 proposed that beginning in taxation year 2004, the education credit be extended to students who pursue post-secondary education related to their current employment, provided that their employer does not reimburse the cost of education in whole or in part.

[5] The 2000 budget raised the exemption for scholarship, fellowship and bursary income from $500 to $3,000 for students eligible for the education credit. In addition, for 2000 and later tax years, the tax expenditure reflects the additional funds made available to students under the Canada Millennium Scholarship Foundation.

[6] The tax expenditure equals the tax revenue forgone on the tax-sheltered income earned on RESP assets, minus the revenue from taxing withdrawals of income from RESPs (as an Educational Assistance Payment or Accumulated Income Payment). The estimates and projections for RESPs are higher than in last year's publication due to better data on the income levels of RESP subscribers. The projections include the anticipated impact of the Canada Learning Bond, starting in 2004, and an enhanced Canada Education Savings Grant, starting in 2005, which were proposed in the 2004 budget.

[7] This measure was proposed in the 2004 budget.

[8] Increases in the tax expenditure after 1999 reflect the higher value of the stock option deduction, which was increased to 50 per cent in 2000 to reflect the reduced inclusion rate for capital gains. The results for 2000 and, to a lesser extent, 2001 were also affected by market appreciation, especially in the technology sector, as well as increased take-up. Projections for 2003 and subsequent years reflect an assumption of reduced market volatility and reduced take-up due to non-tax considerations.

[9] Although the program year is July–June, payments are reported on a calendar year basis. The 2000 budget and the October 2000 *Economic Statement and Budget Update* fully indexed the CCTB starting January 2000, increased the per-child benefit amounts and the National Child Benefit (NCB) supplement and CCTB base benefit phase-out thresholds and, effective July 1, 2004, reduced the CCTB base benefit phase-out rates. The 2003 budget increased the NCB supplement, beyond indexation adjustments, by an annual amount of $150 per child in July 2003, $185 in July 2005 and $185 in July 2006. The projections for 2003 to 2006 do not include the projections for the Child Disability Benefit, which are shown separately.

[10] The October 2000 *Economic Statement and Budget Update* increased the amount on which the caregiver and infirm dependant credit are based from $2,386 in 2000 to $3,500 in 2001. The amount is indexed to inflation for subsequent years.

Table 1
Personal Income Tax Expenditures *(cont'd)*

[11] The spouse or common-law partner credit was previously known as the spousal credit. The eligible dependant credit was previously known as the equivalent-to-spouse credit.

[12] The decline in this tax expenditure after 1999 reflects, in part, reductions to the inclusion rate for capital gains from three-quarters to one-half in 2000.

[13] The projected tax expenditure for 2004 is slightly higher than in other years due to the effects of the outbreak of avian flu in British Columbia. Because this provision is a deferral measure, the deferred income from 2004 will be reported in 2005, resulting in a negative tax expenditure that year.

[14] Estimates are based on Statistics Canada data available up to 2003, which include cash purchase tickets for wheat, barley, oats, canola, flax and rye. Projections after 2003 are calculated using a historical average growth rate.

[15] The data for the Net Income Stabilization Account (NISA) program are observed up to 2003. Since NISA has been replaced by the Canadian Agricultural Income Stabilization (CAIS) program, tax expenditure projections reflect wind-down provisions that require amounts in NISA accounts be withdrawn by March 31, 2009. Projections also reflect recent data from Statistics Canada indicating that withdrawals from the government portion of NISA accounts reached record levels in the first half of 2004. Farmers extracted $703 million from their government accounts, or over three times the previous five-year average of $232 million. It should also be noted that CAIS does not result in a tax expenditure.

[16] Data for unincorporated businesses are not available to estimate this tax expenditure with precision.

[17] The estimates and projections for this tax expenditure are different from those in previous publications due to a change in the methodology for calculating effective marginal tax rates.

[18] The estimates and projections have been revised to reflect recent data and a one-year extension announced in the 2004 budget of the temporary measure. The negative figure for 2006 reflects the inclusion in income for that year of an amount equal to the credit claimed in 2005. A deduction for the full amount of the eligible exploration expenditure is allowed for the year for which the credit is claimed. An amount equal to the credit is required to be included in income the following year, however, so as to reverse the deduction in respect of the portion of the expenditure that was effectively paid for by the credit.

[19] The 2000 budget reduced the capital gains inclusion rate from three-quarters to two-thirds, effective February 28, 2000. The October 2000 *Economic Statement and Budget Update* further reduced the capital gains inclusion rate from two-thirds to one-half, effective October 18, 2000. Increases in this tax expenditure after 1999 reflect reductions to the capital gains inclusion rate as well as anticipated increases in capital gains realizations resulting from changes to this measure.

[20] No data are available, as it is difficult to estimate the value of unsold assets.

Table 1
Personal Income Tax Expenditures *(cont'd)*

[21] The decline in this tax expenditure for 2001 and subsequent years reflects the reduction in the capital gains inclusion rate from three-quarters to one-half in 2000. The decline from 2000 to 2001 is also the result of a 28-per-cent reduction in the number of claimants making use of this measure and a 26-per-cent reduction in the average amount of capital gain that they reported for the purpose of this measure.

[22] The projections of this tax expenditure for 2002 and 2003 are based on preliminary information on sales of shares of labour-sponsored venture capital corporations (LSVCCs) for those years; the decline in the tax expenditure is the result of reduced sales of LSVCC shares. Projections assume sales remain constant after 2003.

[23] The CDB is delivered as a supplement to the Canada Child Tax Benefit. The CDB came into effect in July 2003.

[24] The 2000 budget enhanced the DTC by extending eligibility to individuals requiring extensive therapy and by expanding the list of relatives to whom the DTC can be transferred. The 2000 budget also provided a supplement of up to $500 for children eligible for the DTC. The October 2000 *Economic Statement and Budget Update* increased the amount on which the DTC is based from $4,293 to $6,000 effective 2001.

[25] The increase in the projected tax expenditure reflects anticipated growth in medical expense claims as well as enhancements to the credit announced in the 2003 and 2004 budgets.

[26] Although this measure does provide tax relief for individuals, it is implemented through the corporate tax system. See "interest credited to life insurance policies" under "other measures" in Table 2 of this report for an estimate of the value of this tax expenditure.

[27] The decline in this tax expenditure after 1999 reflects changes in the 1998 to 2000 budgets and the October 2000 *Economic Statement and Budget Update* to reduce tax rates for low-income individuals (e.g. increases in the personal amounts and the reduction in the lowest tax rate).

[28] The change in the net tax expenditure for 2001 and 2002 relative to prior years reflects lower observed asset levels and corresponding lower rates of return for those years. In particular, total adjusted assets in RPPs and RRSPs are estimated to have declined from about $1.244 trillion in 2000 to $1.239 trillion in 2001, resulting in a negative return on investment. For 2002, total adjusted RPP/RRSP assets remained virtually unchanged compared to 2001. These lower asset levels significantly lower the tax expenditure associated with the tax forgone on RPP/RRSP investment income, resulting in a substantial decline in the net tax expenditure for both RPPs and RRSPs in 2001 and 2002. This illustrates the importance of the investment income component in determining the net tax expenditure. Since the observed level of RPP and RRSP assets for 1999 to 2002 is used to determine the rate of return on investment, the tax expenditure will naturally vary from year to year, depending on the derived rate of return. Tax expenditure estimates will be higher in years where assets grow strongly, reflecting the tax forgone on that investment income, and lower in years where assets grow slowly or decline. Given the sizeable effect of rate of return variations on the tax expenditure, there could be considerable variation from year to year.

[29] The 1999 RRSP assets are based on the estimate reported in Statistics Canada's Survey of Financial Security (SFS). The ratio of 1999 RRSP assets reported in the SFS to 1999 RRSP assets reported in the Statistics Canada publication *Pension Plans in Canada* is used to adjust RRSP assets for 2000, 2001 and 2002 to reflect the more comprehensive SFS estimate, which includes funds in self-administered plans (the ratio is $408 billion/ $268 billion or 1.52).

Table 1
Personal Income Tax Expenditures *(cont'd)*

[30] The present-value estimates reflect the lifetime cost of a given year's contributions. This definition is different from that used for the cash-flow estimates, and thus the two sets of estimates are not directly comparable. Further information on how these estimates are calculated is contained in the paper *Present-Value Tax Expenditure Estimates of Tax Assistance for Retirement Savings*, which was published in the 2001 edition of this report.

[31] The present-value tax expenditure projections presented in this year's report are generally lower than in last year's report due to changes in projected RPP/RRSP contribution levels and updated estimates of applicable tax rates.

[32] The decline in the tax expenditure for the partial inclusion rate for 2001 reflects the reduction in the capital gains inclusion rate in 2000 from three-quarters to one-half. Projected tax expenditures reflect anticipated increases in home resales and resale housing prices. The estimates for this tax expenditure can vary significantly from year to year. This is primarily the result of unanticipated year-to-year fluctuations in the number of residence resales and in the average price of residences.

[33] The 2000 budget increased the deduction limit from $7,000 to $10,000 for children eligible for the disability tax credit.

[34] The 2004 budget proposes to replace the attendant care deduction with a broader disability supports deduction, beginning with the 2004 tax year.

[35] Projections have been revised downward to reflect market conditions.

[36] This includes employee- and employer-paid premiums by and for self-employed workers.

[37] Prior to 2001, self-employed individuals could claim a non-refundable credit at the lowest marginal rate on the employer share of their Canada/Quebec Pension Plan contributions. For 2001 and subsequent years, self-employed individuals may deduct the employer share of their Canada/Quebec Pension Plan contributions paid for their own coverage. The estimates and projections shown are relative to a benchmark system in which no such deduction (or credit) is provided.

[38] The 1999 budget extended the benefit of this credit to all taxpayers through the basic personal and spousal/equivalent-to-spouse credits effective July 1, 1999.

[39] This tax expenditure applies to a subset of resource-related deductions. Data are available for 1999 to 2003 on the volume of reclassified shares and are used to calculate 1999 to 2001 estimates and the 2002 and 2003 projections. Due to volatility, the projections for 2004 to 2006 are based on a three-year historical average.

Table 1
Personal Income Tax Expenditures *(cont'd)*

[40] A number of substantial methodological difficulties call into question the accuracy and utility of estimates of the revenue implications of non-taxation of lottery and gambling winnings. The first methodological difficulty is that the data on payouts/winnings are incomplete. There is solid information on aggregate payouts only for government-run lotteries and bingos. Data on payouts at casinos, video lottery terminals, horseracing, and racetrack slot machines, which constitute a rising share of total spending on gaming, is fragmentary. In addition, no data is available on the payouts/winnings from activities sponsored by charities and other non-government organizations. Second, even if complete information on aggregate payouts were available, the revenue implications of non-taxation still could not be determined with precision. For example, if the benchmark tax system were to include taxation of gambling and lottery winnings, consideration would have to be given to including a deduction for expenses incurred in earning this income, i.e. ticket purchases or wagers/losses. This deduction could be allowed either against all income or against only lottery and gambling winnings. A threshold below which winnings would not be taxable would also be necessary due to the large administrative cost of taxing very small prizes. In the absence of information on the distribution of prizes and the incomes of winners, the resulting potential tax base is difficult to estimate. Further, it would be impractical to tax some forms of winnings (e.g. slot machines) because of the way in which prizes are paid out.

Another important point to note with respect to the non-taxation of lottery and gambling winnings is that under federal-provincial agreements negotiated in 1979 and 1985, the federal government, in exchange for an ongoing payment, undertook to refrain from re-entering the field of gaming and betting and to ensure that the rights of the provinces in that field are not reduced or restricted.

[41] Allowances for members of Parliament and senators are no longer tax-exempt, effective January 2001.

Table 2
Corporate Income Tax Expenditures*

	Estimates		Projections[1]					
	1999	2000[2]	2001	2002	2003	2004	2005	2006
	($ millions)							
Charities, Gifts and Contributions								
Deductibility of charitable donations	255	275	260	250	270	275	295	315
Deductibility of gifts of cultural property and ecologically sensitive land	5	15	15	25	10	10	10	10
Deductibility of gifts to the Crown	S	S	S	S	S	S	S	S
Non-taxation of registered charities	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Non-taxation of other non-profit organizations (other than registered charities)	95	130	155	140	125	125	130	135
Political contribution tax credit	S	S	S	S	S	S	S	S
Culture								
Canadian film or video production tax credit	145	170	165	170	180	185	195	205
Non-deductibility of advertising expenses in foreign media[3]	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Federal-Provincial Financing Arrangements								
Income tax exemption for provincial and municipal corporations	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Transfer of income tax room to provinces	935	1,160	1,145	1,065	1,225	1,310	1,395	1,470
Logging tax credit	46	36	18	23	24	25	27	28
General Business and Investment								
Accelerated write-off of capital assets and resource-related expenses	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Deferral through capital gains rollovers[4]	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Taxation of capital gains upon realization[5]	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Partial inclusion of capital gains[6]	1,250	2,465	3,820	2,345	2,420	2,475	2,590	2,720
Expensing of advertising costs[7]	65	44	44	44	44	44	44	44
Atlantic investment tax credit[8]	76	82	105	110	110	115	120	125
Scientific research and experimental development investment tax credit[8]	1,310	1,445	1,605	1,635	1,700	1,750	1,810	1,865

*** The elimination of a tax expenditure would not necessarily yield the full tax revenues shown in the table. See the publication *Tax Expenditures: Notes to the Estimates/Projections*, available on the Department of Finance Web site at www.fin.gc.ca, for a discussion of the reasons for this.**

Table 2
Corporate Income Tax Expenditures *(cont'd)*

	Estimates		Projections[1]					
	1999	**2000[2]**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**
	($ millions)							
Investment tax credits earned in current year but carried back to prior years	58	88	88	90	94	97	100	105
Investment tax credits claimed in current year but earned in prior years	655	685	670	660	700	720	750	775
Write-off of capital assets before available for use	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Small Business								
Deduction of allowable business investment losses[9]	30	34	28	27	25	24	24	25
Interest on small business financing loans	S	S	–	–	–	–	–	–
Low tax rate for small businesses[10]	3,200	3,310	3,355	3,075	2,745	2,620	2,845	3,005
Accelerated rate reduction for small businesses[11]	–	–	65	80	40	10	–	–
Non-taxation of provincial assistance for venture investments in small business	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
International								
Exemption from Canadian income tax of income earned by non-residents from the operation of a ship or aircraft in international traffic	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Exemption from tax for international banking centres	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Exemptions from non-resident withholding tax[12]								
Dividends	220	205	230	275	275	265	350	440
Interest								
On deposits[13]	410	495	365	170	160	155	180	190
On long-term corporate debt	115	130	125	130	125	120	140	150
Other[14]	345	385	385	340	320	315	365	385
Rents and royalties								
Copyright royalties	23	23	28	24	25	27	29	31
Royalties for the use of, or right to use, other property	23	20	35	83	88	93	99	105
Research and development royalties	S	S	S	4	4	4	5	5
Natural resource royalties	S	S	S	S	S	S	S	S
Rents from real property	S	S	S	S	S	S	S	S

Table 2
Corporate Income Tax Expenditures *(cont'd)*

	Estimates		Projections[1]					
	1999	2000[2]	2001	2002	2003	2004	2005	2006
				($ millions)				
Management fees	46	45	36	44	51	53	56	59
Estate or trust income	16	33	11	21	23	24	25	26
Non-taxation of life insurance companies' world income	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Tax exemption, or credit for foreign taxes paid, on income of foreign affiliates of Canadian corporations	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Sectoral Measures								
Farming								
Cash basis accounting	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Deferral of income from destruction of livestock	S	S	S	S	S	S	S	S
Deferral of income from grain sold through cash purchase tickets	20	5	-15	15	S	S	S	S
Flexibility in inventory accounting	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Resource								
Corporate mineral exploration tax credit[15]	–	–	–	–	22	29	40	39
Deductibility of contributions to a qualifying environmental trust	S	S	S	S	S	S	S	S
Earned depletion[16]	39	40	43	66	69	67	59	51
Net impact of the resource allowance and the limited deductibility of Crown royalties and mining taxes[17]	115	130	29	215	310	225	240	110
Tax rate on resource income[18]	–	–	-60	-215	-390	-535	-410	-190
Transitional arrangement for the Alberta Royalty Tax Credit	–	–	–	–	S	S	S	S
Other Sectors								
Exemption from branch tax for transportation, communications, and iron ore mining corporations	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Film or video production services tax credit[19]	53	62	67	67	100	105	110	115
Low tax rate for credit unions[20]	38	52	75	79	75	65	68	72
Manufacturing and processing allowance[21]	1,900	2,150	1,440	950	530	100	–	–
Surtax on the profits of tobacco manufacturers	-70	-40	-80	-80	-80	-80	-80	-80
Temporary tax on the capital of large deposit-taking institutions[22]	-58	-48	–	–	–	–	–	–

Table 2
Corporate Income Tax Expenditures *(cont'd)*

	Estimates		Projections[1]					
	1999	2000[2]	2001	2002	2003	2004	2005	2006
	($ millions)							
Other Measures								
Deductibility of countervailing and anti-dumping duties	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Deductibility of earthquake reserves[23]	5	6	7	5	5	5	5	5
Deferral through use of billed basis accounting by professional corporations	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Holdback on progress payments to contractors[24]	55	40	40	40	40	40	40	40
Interest credited to life insurance policies	98	91	66	68	69	71	73	75
Income tax exemption of certain federal Crown corporations	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Memorandum Items								
Mechanisms for the Integration of Personal and Corporate Income Tax								
Investment corporation deduction[25]	S	S	S	S	S	11	13	16
Refundable capital gains for investment corporations and mutual fund corporations[26]	425	645	520	530	550	355	330	305
Refundable taxes on investment income of private corporations								
Additional Part I taxes[27]	-525	-625	-570	-695	-875	-1,105	-1,200	-1,295
Part IV tax	-1,515	-1,720	-1,545	-1,490	-1,565	-1,695	-1,850	-1,995
Dividend refund	2,885	3,255	3,115	3,010	3,175	3,445	3,765	4,065
Net expenditure	845	910	1,000	825	735	645	715	775
Expenses Incurred to Earn Income								
Deduction for intangible assets	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Deductibility of provincial royalties (joint venture payments) for the Syncrude project (remission order)[28]	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	–	–
Loss Offset Provisions								
Capital loss carry-overs[29]								
Net capital losses carried back	155	175	215	225	210	160	130	135
Net capital losses applied to current year	550	705	570	320	330	340	355	370
Farm and fishing loss carry-overs[29]	24	20	19	19	19	18	19	20

Table 2
Corporate Income Tax Expenditures *(cont'd)*

	Estimates		Projections[1]					
	1999	2000[2]	2001	2002	2003	2004	2005	2006
				($ millions)				
Non-capital loss carry-overs[29]								
Non-capital losses carried back	1,410	1,030	1,305	1,310	1,310	1,280	1,255	1,280
Non-capital losses applied to current year	3,725	4,085	3,380	3,450	3,550	3,445	3,660	3,735
Other								
Aviation fuel excise tax rebate[30]	n.a.	n.a.	–	–	–	–	–	–
Non-resident-owned investment corporation (NRO) refund[31]	230	280	280	420	420	–	–	–
Partial deduction of meals and entertainment expenses[32]	330	345	330	320	315	310	325	340
Patronage dividend deduction[33]	270	190	255	330	235	230	250	260

Notes:

1 Unless otherwise indicated in the footnotes, changes in the projections from those in last year's edition of this document result from changes in the explanatory economic variables upon which the projections are based. Projections for 2001 and subsequent years reflect the impact of the reduction in the general corporate income tax rate from 28 per cent to 27 per cent on January 1, 2001, 25 per cent on January 1, 2002, 23 per cent on January 1, 2003, and 21 per cent on January 1, 2004. The corporate surtax raises these rates by 1.12 percentage points.

2 2000 estimates are based on preliminary data.

3 This treatment should result in a negative tax expenditure since the deduction of an expense incurred to earn income is denied. Under the benchmark tax system, advertising expenses in foreign media incurred to gain or produce income from a business or property would be deductible whether targeted at foreign or domestic markets.

4 This is a tax expenditure because under the benchmark system capital gains would be taxed on an accrual basis.

5 The tax deferral associated with taxation of capital gains upon disposition of property, rather than on an accrual basis, represents a deviation from the benchmark tax system and is therefore a tax expenditure.

6 The 2000 budget reduced the capital gains inclusion rate from three-quarters to two-thirds, effective February 28, 2000. The October 2000 *Economic Statement and Budget Update* further reduced the capital gains inclusion rate from two-thirds to one-half, effective October 18, 2000. Increases in this tax expenditure for 2000 and 2001 reflect increased capital gains and the reduction in the capital gains inclusion rate. The decline in 2002 reflects a projected decrease in capital gains as well as the reduction in the corporate income tax rate.

Table 2
Corporate Income Tax Expenditures *(cont'd)*

[7] This treatment results in a positive tax expenditure because advertising expenses can provide benefits in more than one year. Under the benchmark tax system, advertising expenses would be amortized over the benefit period. The amount of this tax expenditure can fluctuate significantly from year to year depending upon advertising expenses claimed. Therefore it is projected at its historical average.

[8] The tax expenditure amount is the investment tax credit earned and claimed in the year.

[9] The amount of this tax expenditure can fluctuate from year to year depending upon the amount of current-year losses and the availability of income against which to apply these losses.

[10] The increase in the expenditure from 1999 to 2001 is attributable to an increase in taxable income. The reduction in the tax expenditure from 2001 to 2004 results from reductions in the general statutory rate of corporate income tax (the benchmark rate) and a lower growth track for projected taxable income. Projections after 2002 include the positive impact for this tax expenditure of the 2003 budget increase in the amount of income eligible for the small business deduction, and the 2004 budget proposal to accelerate this increase.

[11] This measure was announced in the 2000 budget and became effective January 1, 2001. On that date the general federal corporate income tax rate on income between $200,000 and $300,000 earned by a Canadian-controlled private corporation from an active business carried on in Canada was reduced to 21 per cent. The lower rate on the general income of small businesses and the change in the general federal tax rate effective January 1, 2001, only partially affect the projection for tax year 2001 since many firms reporting income in the 2001 tax year earned a portion of that income in the 2000 calendar year, before the rate reductions were introduced. Declines in the tax expenditure after 2002 are a result of the reduction in the general corporate income tax rate and the increase, announced in the 2003 budget, in the amount of income eligible for the small business deduction. This measure was effectively eliminated on January 1, 2004, when the general corporate income tax rate was reduced to 21 per cent. Some tax expenditure occurs in 2004, however, as many firms reporting income in the 2004 tax year will earn a portion of that income in the 2003 calendar year.

[12] Estimates and projections were computed on the basis of an analysis of payments to non-residents and withholding tax collections available for 1999 to 2002.

[13] The decline in 2002 reflects changes in the payments and exemptions as observed from newly available data. Projections for the 2003 to 2006 period have been revised accordingly.

[14] This category includes interest paid to non-resident persons or organizations that would be exempt from income tax in Canada were they residents in Canada. Also included is interest paid under certain securities-lending arrangements exempt under subparagraph 212(1)(b)(xii) of the Income Tax Act, and interest exempt under certain other domestic and treaty provisions.

[15] This tax credit was introduced in the 2003 budget and applies to 2003 and subsequent tax years. It is phased in starting at 5 per cent in 2003, 7 per cent in 2004 and 10 per cent in subsequent years.

[16] Additions to earned depletion pools were eliminated as of January 1, 1990. Determination of the tax expenditure reflects the projected use of existing earned depletion pools.

[17] The tax expenditure is calculated as the revenue cost of the resource allowance net of non-deductible Crown royalties and provincial mining taxes. Over a five-year period beginning in 2003, the resource allowance is being phased out and a deduction for Crown royalties and mining taxes phased in so that, by 2007, the tax expenditure is effectively reduced to zero. See the technical paper *Improving the Income Taxation of the Resource Sector in Canada*, Department of Finance, March 2003, for further details.

[18] Budget 2003 announced an extension to resource income of the lower general corporate tax rate, to be phased in over five years beginning in 2003. By 2007, when the resource rate equals the general rate, the tax expenditure amount will be reduced to zero. See the technical paper *Improving the Income Taxation of the Resource Sector in Canada*, Department of Finance, March 2003.

[19] Projections for 2003 and subsequent years reflect the impact of the 2003 budget proposal to increase the rate of the credit from 11 per cent to 16 per cent.

[20] Credit unions are eligible for the lower federal tax rate of 12 per cent provided to small businesses. The projected increase in 2001 is due to higher taxable income of credit unions. The projections are lower after 2003 due to the increase in the income eligible to the small business tax rate, as announced in the 2003 and 2004 budgets, and the reductions in the general corporate income tax rate.

[21] Although this tax expenditure was eliminated on January 1, 2004, when the general corporate tax rate was reduced to 21 per cent, many firms reporting income in the 2004 taxation year will earn a portion of that income in the 2003 calendar year, before the tax expenditure was effectively eliminated.

[22] This measure expired on October 31, 2000.

[23] The 1999 to 2001 estimates and projections are based on 1999 to 2001 data from the Office of the Superintendent of Financial Institutions and correspond to the estimates and projections published in last year's tax expenditure publication.

[24] The amount of this tax expenditure can fluctuate significantly from year to year depending primarily upon the level of construction activity. Therefore, it is projected based on its historical average.

[25] This measure allows a public corporation that qualifies as an investment corporation to benefit from elements of the integration system, which are usually available only to private corporations.

[26] The increase in the 2000 tax expenditure is due to a significant increase in the capital gain dividends distribution. The projections decline starting in 2001 due to the reduction in the capital gains inclusion rate, and fall further in 2004 due to declining capital gains.

[27] This tax expenditure includes the additional 6 2/3 per cent refundable tax on investment income as well as, for years after 2000, the Part I tax paid on investment income in excess of the benchmark rate. The increase in this expenditure after 2001 results from the increase in the difference between the Part I tax on investment income and the benchmark rate.

Table 2
Corporate Income Tax Expenditures *(cont'd)*

[28] The cost of the Syncrude Remission Order ("Order Respecting the Remission of Income Tax for the Syncrude Project," P.C. 1976-1026, May 6, 1976 [C.R.C. 1978 Vol. VII, c. 794]) is published annually in the Public Accounts of Canada (ISBN 0-660-177792-7). The order expired on December 31, 2003.

[29] The impact of loss carry-overs can fluctuate significantly from year to year depending upon the amount of current and prior years' losses and the availability of income against which to apply these losses.

[30] The aviation fuel excise tax rebate, which was effective for calendar years 1997 to 2000, provided an excise tax rebate on the aviation fuel used by airline companies. The rebate was limited to $20 million per year per associated group of companies. In order to receive a rebate, a company had to agree to reduce its income tax losses by $10 for every $1 of rebate.

[31] This measure was repealed in 2000. To allow for an orderly restructuring of their operations, however, existing NROs were entitled to retain their status until the end of their last tax year that began before 2003.

[32] Fifty per cent of these expenses are deductible for income tax purposes, given that a portion of meal and entertainment expenses is incurred to earn income and is therefore a legitimate business expense, while the remaining portion reflects personal consumption. The estimates and projections provided reflect the additional tax revenue that would be received if no deduction were allowed.

[33] Patronage dividends are somewhat discretionary and vary from year to year. The projections are generally lower after 2000 to take into account the phased-in reductions in the general corporate income tax rate. The large increase in the 2002 projection is due to larger-than-usual patronage dividends in that year.

Table 3
GST Tax Expenditures*

	Estimates				Projections			
	1999	2000	2001	2002	2003	2004	2005	2006
	($ millions)							
Aboriginal Self-Government								
Refunds for Aboriginal self-government[1,2]	S	S	S	S	S	S	S	S
Business								
Exemption[3] for domestic financial services	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Exemption for ferry, road and bridge tolls[4]	5	5	5	5	5	5	5	5
Exemption and rebate for legal aid services	20	20	25	25	25	30	30	30
Non-taxability of certain importations[5]	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Rebates for foreign visitors on accommodations[6]	79	79	86	86	75	81	87	92
Small suppliers' threshold	135	145	155	170	175	180	190	200
Zero-rating[7] of agricultural and fish products and purchases	S	S	S	S	S	S	S	S
Zero-rating of certain purchases made by exporters	S	S	S	S	S	S	S	S
Charities and Non-Profit Organizations								
Exemption for certain supplies made by non-profit organizations	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Rebates for registered charities[1]	190	215	235	250	270	280	295	310
Rebates for non-profit organizations[1]	50	55	60	60	65	70	70	75
Education								
Exemption for education services (tuition)[4]	360	365	390	410	435	450	475	500
Rebates for book purchases made by qualifying public institutions	30	30	30	35	35	35	40	40
Rebates for colleges[1]	60	65	80	85	85	90	95	100
Rebates for schools[1]	335	350	375	380	400	420	440	465
Rebates for universities[1]	135	150	180	205	215	225	240	250

*** The elimination of a tax expenditure would not necessarily yield the full tax revenues shown in the table. See the publication *Tax Expenditures: Notes to the Estimates/Projections*, available on the Department of Finance Web site at www.fin.gc.ca, for a discussion of the reasons for this.**

Table 3
GST Tax Expenditures *(cont'd)*

	Estimates				Projections			
	1999	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**
	($ millions)							
Health Care								
Exemption for health care services[4]	450	480	490	500	530	550	580	610
Rebates for hospitals[1]	315	340	390	395	420	440	460	485
Zero-rating of medical devices[4]	115	130	140	150	155	165	170	180
Zero-rating of prescription drugs[4]	400	440	475	510	535	555	585	620
Households								
Exemption for child care and personal services[4]	135	135	135	135	140	145	155	160
GST/HST credit[8]	2,915	2,965	3,005	3,070	3,150	3,240	3,360	3,455
Zero-rating of basic groceries[4]	3,085	3,215	3,390	3,540	3,720	3,875	4,085	4,300
Housing								
Exemption for sales of used residential housing and other personal-use real property	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Exemption for residential rent (long-term)[4]	1,100	1,105	1,085	1,110	1,180	1,230	1,300	1,360
Rebates for new housing[9]	555	590	630	775	865	960	1,025	1,075
Rebates for new residential rental property[10]	–	25	40	45	50	55	60	60
Municipalities								
Exemption for municipal transit[4]	75	90	95	105	110	115	120	125
Exemption for water and basic garbage collection services[4]	125	135	135	145	155	160	170	180
Rebates for municipalities[1,11]	615	645	700	720	760	1,360	1,445	1,505
Memorandum Items								
Recognition of Expenses Incurred to Earn Income								
Rebates to employees and partners[12]	90	105	105	105	110	110	110	110
Other								
Exemption for quick method accounting	175	190	200	205	215	225	240	250
Partial input tax credits for meals and entertainment expenses[13]	130	140	145	150	155	160	170	180

Table 3
GST Tax Expenditures *(cont'd)*

Notes:

[1] The public sector body rebates are based on Canada Revenue Agency administrative data for the years up to and including 2002. The projected values for 2003 onwards are based on the Sales Tax Model of the Department of Finance. This projection methodology differs from that in last year's publication, and this explains some of the revisions in the projections for 2003 and later years.

[2] These refunds are paid to Aboriginal governments that have an agreement providing for a GST/HST refund for goods and services acquired for self-government activities.

[3] Final consumers and businesses pay no tax on exempt goods and services. Vendors, however, are not entitled to claim input tax credits to recover the GST/HST paid on inputs to these products.

[4] The Sales Tax Model used to generate these estimates and projections is based on the 2000 national input-output tables from Statistics Canada and the latest release of the National Income and Expenditure Accounts.

[5] Certain importations are tax-free including, for example, duty-free personal importations by Canadian travellers.

[6] The methodology for estimating this tax expenditure was derived as part of the review of the Visitors' Rebate Program conducted during 1997 and has been updated to reflect more recent information. The reduction in rebates for foreign visitors in 2003 reflects a reduction in the number of foreign visitors to Canada in that year.

[7] Final consumers and businesses pay no tax on zero-rated goods and services. Vendors of zero-rated products are entitled to claim input tax credits to recover the GST/HST paid on inputs to these products.

[8] Based on personal income tax data.

[9] Estimates for the housing rebate are based on information provided by Statistics Canada. The increase in rebates for new housing in 2002 is larger than the increases in 2000 and 2001, reflecting higher numbers of new homes sold as well as increases in the average price of new homes in 2002. For 2003 and subsequent years, the increases in rebates for new housing reflect projected increases in expenditures on new homes.

[10] The new residential rental property rebate was introduced in the 2000 budget for new construction or substantial renovation commencing after February 27, 2000.

[11] The rebate rate for municipalities was increased from 57.14 per cent to 100 per cent effective February 1, 2004.

[12] This item includes the apprentice vehicle mechanics' tools deduction.

[13] Based on tax expenditure estimates and projections reported for the personal and corporate income tax systems.

PART 2
TAX EVALUATIONS AND RESEARCH REPORTS

THE DISABILITY TAX CREDIT: EVALUATION REPORT

1. Introduction and Summary

The Government of Canada is committed to supporting full participation for persons with disabilities in Canadian society. As part of this commitment, the Government provides substantial direct assistance to persons with disabilities. Examples of this assistance include the Child Disability Benefit (a supplement to the Canada Child Tax Benefit), Canada Study Grants for students with disabilities to help with the costs of post-secondary education, funding for the Labour Market Agreements for Persons with Disabilities with the provinces and territories, Canada Pension Plan disability benefits, and disability pensions for veterans.

Another important aspect of the Government of Canada's commitment to persons with disabilities is ensuring that Canadians with disabilities are treated fairly by the tax system. Persons with disabilities and their supporting families may incur extra non-discretionary expenses related to their condition that reduce their ability to pay tax. Without recognition of these additional expenses, they would face the same tax bill as persons with identical income who do not have these costs. Tax fairness is therefore improved when the extra costs of disability are recognized in the tax system. Currently these expenses are recognized by three types of tax measures.

- Tax credits for specific expenses related to disability: the medical expense tax credit and the recently proposed disability supports deduction.
- The disability tax credit (DTC), which provides relief for extra everyday expenses incurred by persons with disabilities.
- Tax credits providing relief for individuals caring for family members with disabilities: the caregiver credit, the infirm dependant credit and the eligible dependant credit.

In the Government's response to the Seventh Report of the Standing Committee on Human Resources Development and the Status of Persons with Disabilities, it was agreed that an evaluation of the DTC would be conducted by the Department of Finance. This evaluation assesses whether the DTC is achieving its policy intent of contributing to tax fairness for persons with disabilities.

The evaluation shows that:

- The DTC improves tax fairness for over 400,000 Canadians with severe and prolonged disabilities, as well as their supporting families. While there are other tax measures that help persons with disabilities, only the DTC recognizes the extra spending on everyday items that reduce the ability to pay tax.
- An aggregate comparison suggests that the DTC is reaching its target population—Canadians with severe and prolonged disabilities. Estimates of the DTC recipient population based on Statistics Canada survey data are in the same range as the actual number of DTC recipients. It is not possible with available data, however, to determine whether a given individual reporting a severe and prolonged disability receives the DTC.

- Better information will be required to assess whether the DTC dollar amount is set at the right level. Steps are being taken to try to develop better data on the extra spending on everyday items incurred by persons with disabilities.

The evaluation is organized as follows:

- Section 2 provides background information on the DTC and key disability-related tax measures.
- Section 3 discusses the importance of tax fairness for persons with disabilities and considers the DTC's policy role in this context.
- Section 4 uses survey data on activity limitations to assess whether the DTC is reaching its intended recipients.
- Section 5 discusses the issues associated with determining if the DTC amount is set at the right level.
- Section 6 presents the conclusions of the evaluation.
- An annex provides further detail on tax measures that benefit persons with disabilities.

2. Description of the DTC and Other Tax Measures That Benefit Persons With Disabilities

This section describes the main federal tax measures that promote tax fairness for persons with disabilities and their supporting families (i.e. measures that recognize that individuals with disabilities and their families incur extra costs that reduce their ability to pay tax). It first provides background information on the DTC, and then describes other tax measures recognizing disability-related expenses and tax credits for individuals caring for family members with disabilities.[1]

The Disability Tax Credit

The DTC is a non-refundable credit implemented to recognize that individuals with severe and prolonged impairments incur additional expenses related to their disability that reduce their ability to pay income tax.

Origins. The Canadian tax system has a long history of recognizing the additional expenses of disability. In 1944 a deduction was introduced for blind persons in recognition of their additional expenses. A few years later this deduction was extended to individuals confined to a bed or who use a wheelchair. In the mid-1980s the definition of eligibility for the disability deduction was extended to include individuals with a severe and prolonged mental or physical disability that markedly restricts a basic activity of daily living. The deduction was converted into a credit in 1988.

[1] In addition, some tax measures include special provisions for persons with disabilities. These measures are described in the Annex.

Eligibility. The DTC provides tax relief to individuals who, due to the effects of a severe and prolonged mental or physical impairment, are markedly restricted in their ability to perform a basic activity of daily living as certified by a qualified medical practitioner, or would be markedly restricted were it not for extensive therapy to sustain a vital function. Individuals are markedly restricted if, even with therapy or the use of appropriate devices and medication, they are blind or unable to perform a basic activity of daily living, or if they require an inordinate amount of time to perform the activity, all or substantially all of the time. The basic activities of daily living are: walking; feeding or dressing oneself; perceiving, thinking and remembering; speaking; hearing; and eliminating bodily waste.

In addition, since the 2000 tax year, an individual who receives therapy essential to sustain a vital function (e.g. dialysis treatment) may be eligible to claim the DTC.[2]

Eligibility is determined by an assessment conducted by a medical professional. While medical doctors can certify all types of impairments, other professionals are limited to certifying impairments in their respective fields, as summarized in the following table.

Table 1
Professional Certification of DTC Eligibility

Medical professional	Type of impairment
Medical doctors	All impairments
Optometrists	Vision
Audiologists	Hearing
Occupational therapists	Walking, feeding, dressing
Psychologists	Perceiving, thinking and remembering
Speech-language pathologists	Speaking

Parameters. In 2004 the DTC dollar amount is $6,486. This represents a benchmark amount of extra everyday costs incurred by DTC-eligible individuals. No receipts are required to claim the credit—that is, all eligible persons may claim the full amount. The credit amount is multiplied by the lowest marginal tax rate (currently 16 per cent), and the person's federal tax liability is reduced by this amount (currently $1,038). The credit amount is fully indexed to inflation.

Families with children under 18 who are eligible for the DTC are also eligible for a supplement in the amount of $3,784 which, at a credit rate of 16 per cent, translates into an additional reduction in federal taxes of up to $605. The supplement is reduced if child care deductions for this child exceed $2,216 in 2004.

[2] The life-sustaining therapy must be administered at least three times each week for a total duration averaging not less than 14 hours a week, and it cannot reasonably be expected to be of significant benefit to persons who are not so impaired.

Since the DTC is non-refundable—it can be used to reduce taxes to zero, but it does not trigger a payment from the Government when the amount of the credit exceeds tax otherwise payable—it may be the case that an individual with a severe and prolonged disability does not have enough taxable income to make use of any or all of the DTC. In other words, their federal tax liability may be less than $1,038 in 2004, even before the DTC is applied. If someone cannot use all of the DTC himself or herself, the unused portion can be claimed by a family member—either a spouse or another supporting relative. The list of family members eligible to receive a transfer of the DTC has been expanded in recent years, most recently in 2000.[3]

Number of DTC Claims. Most DTC-eligible individuals, even if they do not have enough taxable income to make any use of the credit, can be identified in tax data because they still claim the credit on their own tax return. Some, however, transfer the credit to a supporting relative but do not file their own tax return, and this requires some adjustment to the tax data.

In 2001, the most recent year for which tax return data are available, approximately 344,000 individuals claimed the DTC for themselves. It is possible to use data on the DTC supplement for children to determine that claims were made for 37,000 children with severe and prolonged disabilities. In addition, it is estimated that 20,000 DTC transfers were claimed on behalf of eligible adults who did not file their own tax return.[4] In total, DTC claims were made by, or on behalf of, approximately 400,000 individuals with severe and prolonged impairments in 2001.

Age. It is widely known that disability rates increase with age. The 2001 Participation and Activity Limitation Survey indicated that seniors have the highest rate of disability in Canada (41 per cent).[5] It is not surprising, then, that most DTC-eligible individuals are senior citizens. As Table 2 shows, of those DTC-eligible adults who claimed the DTC on their own tax return in 2001, 60 per cent were 65 or older and 40 per cent were 75 or older. By way of comparison, less than 20 per cent of all tax filers in 2001 were 65 or older.

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[3] A DTC transfer can be claimed on behalf of someone's (or their spouse's or common-law partner's) parent, grandparent, child, grandchild, brother, sister, aunt, uncle, niece or nephew. Brothers, sisters, aunts, uncles, nieces and nephews were added to this list by the 2000 changes.

[4] Since tax return data include detailed information on spouses, it can be shown that in the case of 16 per cent of DTC spousal transfers, or approximately 11,800 claims, the DTC-eligible spouse did not claim the credit himself or herself. If this same 16 per cent ratio were applied to DTC transfers from other adult relatives, there would have been an additional 8,400 transfers with no corresponding self claims, for a total of 20,200.

[5] Human Resources Development Canada, *Disability in Canada: A 2001 Profile*, p. 8.

Table 2
DTC Self Claims by Age, 2001

Age of tax filer	Number of DTC self claims	% of DTC self claims	% of all tax filers
< 25	4,900	1.5	13.6
25-34	12,800	3.7	16.8
35-44	24,500	7.1	21.5
45-54	39,200	11.4	18.6
55-64	54,900	16.0	12.4
65-74	70,400	20.5	9.3
75-84	86,500	25.2	5.8
85 +	50,600	14.7	2.0
Total	343,800	100.0	100.0

Note: Numbers rounded to nearest hundred. Percentages may not add to 100% due to rounding.

Income. Individuals who claimed the DTC for themselves in 2001 had below average incomes (Table 3).[6] There is, however, a substantial difference by age: while the average income of younger self claimants was well below the income of other persons under 65, the incomes of older self claimants in 2001 were not substantially different than the incomes of other seniors. The data suggest that most seniors with a disability developed it relatively late in life. Consequently, they would have approximately the same work history and income as the total population over 65. In contrast, DTC-eligible individuals under 65 have a lower rate of labour force participation and hence lower incomes, on average, relative to other individuals in the same age group.

Table 3
Average Total Income by DTC Status and Age, 2001

Age	Average total income for DTC self claimants	Average total income for others
All ages	$24,612	$31,862
Under 65	$20,881	$32,719
65 and older	$27,062	$27,517

Table 3 also shows that DTC self claimants 65 and older have substantially higher incomes than younger persons with disabilities. The biggest difference by age occurs for individuals with less than $10,000 in income: almost one-third of individuals under 65 making a DTC self claim were in this income category, compared to less than 10 per cent for individuals 65 and over (Table 4). This difference at low income levels likely reflects the availability of Guaranteed Income Supplement payments to persons 65 and over.

[6] The measure of income used in this analysis is personal income, and does not take account of the financial support that DTC-eligible individuals may receive from family members. In addition, this measure excludes various forms of non-taxable income that are not reported on income tax returns, such as disability insurance benefits.

The lower share of seniors having incomes less than $10,000 translates as well into a higher share at all income levels above $10,000, with particularly large differences for incomes up to $30,000.

Table 4
DTC Self Claims by Age and Income, 2001

	Under 65		65 and older		Overall	
Total income	Number	% of <65	Number	% of 5+	Number	% of overall
< $10,000	43,800	32.2	15,500	7.4	59,300	17.3
$10,000 - $20,000	44,600	32.7	91,400	44.0	135,900	39.5
$20,000 - $30,000	20,000	14.7	48,900	23.5	68,900	20.0
$30,000 - $40,000	11,100	8.1	23,200	11.2	34,300	10.0
$40,000 - $80,000	14,600	10.7	23,300	11.2	38,000	11.0
$80,000 +	2,100	1.5	5,200	2.5	7,300	2.1
Total	136,300	100.0	207,500	100.0	343,800	100.0

Note: Numbers rounded to nearest hundred. Percentages may not add to 100% due to rounding.

Tax Relief. In 2001 the DTC provided a reduction in federal taxes of $330 million to Canadians with severe disabilities and their families, up substantially from $275 million in tax relief in 2000. The significant enrichment of the credit amount, from $4,293 in 2000 to $6,000 in 2001, was primarily responsible for this increase. This estimate of tax relief does not include the additional tax relief provided through provincial disability tax credits, which is typically half of the federal amount.

Other Tax Measures That Benefit Persons With Disabilities

Medical Expense Tax Credit

The medical expense tax credit (METC) is a non-refundable credit that recognizes the effect of above-average medical expenses on an individual's ability to pay income tax. The list of eligible METC expenses is quite broad and is regularly reviewed and expanded in light of new technologies and developments. The METC provides a substantial and rapidly growing amount of tax relief to Canadians. In 2001 the total reduction in federal taxes provided by the METC was $570 million.

Although the METC is a measure of general application for all taxpayers, it plays an important role in recognizing out-of-pocket disability expenses. In 2001 the average METC claim for a family making a DTC claim was $1,123, almost five times higher than the average METC claim of $248 for families with no DTC claim (Table 5). Further, families with a DTC claim were more than twice as likely to make an METC claim than families with no DTC claim.

Table 5
METC Claims by DTC Status and Age, 2001

	Overall		< 65		65+	
	DTC	No DTC	DTC	No DTC	DTC	No DTC
Average METC claim	$1,123	$248	$682	$146	$1,568	$768
% with METC claim	33.0%	13.7%	28.0%	11.1%	38.1%	27.3%

The high average METC claim for families with a DTC claim reflects, in large measure, the inclusion of disability-related items in the list of expenses eligible for the METC.[7] Examples of such items include attendant care,[8] fees paid to a group home, tutoring and talking textbooks, communications devices and services, renovations to make a home more accessible, expenses paid to move to a more accessible home, vehicle modifications and guide dogs. More details on the METC and how it has been expanded in recent years to include more items purchased by persons with disabilities are provided in the Annex.

Disability Supports Deduction

The 2004 budget proposed the introduction of a deduction for disability supports for employment and education. The effect of this deduction will be to ensure that no income tax will be payable on income (including government assistance) used to pay for these expenses. Eligible expenses for this new deduction will include, for example, note-taking and tutoring services, sign language interpretation fees, and attendant care purchased for purposes of employment or education. While expenses eligible for the disability supports deductions are generally also eligible for the METC, the expenses can only be claimed under one of the two measures.

Tax Credits for Caregivers

Individuals caring for an adult family member with a disability, other than their spouse, may be able to claim a non-refundable tax credit in recognition of the additional expenses they incur.[9] There are three tax credits associated with caregiving: the caregiver credit, the infirm dependant credit and the eligible dependant credit. Generally, to be able to claim one of these three credits, the adult family member for whom someone is caring has to be "infirm" (except in the case of the caregiver credit, where a dependent parent or grandparent age 65 or more does not have to be infirm). In addition, the dependant's

[7] These expenses can only be claimed if someone is eligible for the DTC.

[8] An individual with a severe and prolonged disability who claims the DTC can claim up to $10,000 in nursing home or attendant care expenses (up to $20,000 in the year of death). If this person's expenses for attendant care are higher than $10,000, he or she also has the option to include all of these expenses in the METC claim, but then the DTC cannot be claimed.

[9] The additional expenses associated with caring for a child under 18 with a disability are essentially recognized by the DTC supplement for children. There are also special child care deduction provisions for children with disabilities; these provisions are described in the Annex.

income must not exceed certain levels. While there is no specific definition of infirmity in tax legislation, a broader definition is implied than the severe and prolonged impairments that serve as the basis of DTC eligibility.[10]

The three credits operate side-by-side as follows:

- If the infirm dependant does not live in the caregiver's home, the infirm dependant credit is the only credit available.
- If the infirm dependant lives in the caregiver's home and the caregiver has a spouse or common-law partner that they live with or support, the only option is the caregiver credit.
- If the caregiver and infirm dependant live in the same home and the caregiver does not have a spouse or common-law partner that they live with or support, the caregiver may be able to claim the eligible dependant credit instead of the caregiver credit. While the eligible dependant credit potentially offers a higher amount of tax relief than the caregiver credit, it cannot be claimed for as many types of relatives. Further, the eligible dependant credit is subject to phase-out provisions that make it no more generous than the caregiver credit beyond a certain income range.

In addition, a DTC-eligible dependant may choose to transfer any unused portion of their DTC to the caregiver. Finally, as proposed in the 2004 budget, a taxpayer can claim medical expenses paid on behalf of a dependent relative that are in excess of the relative's net income threshold, subject to a maximum claim of $5,000.

3. The DTC's Policy Role

An important part of this evaluation is assessing how the DTC contributes to tax fairness by recognizing the impact of additional disability-related costs on the ability to pay tax.

There are two notions of equity that are important in the tax system: vertical equity and horizontal equity. Vertical equity means that individuals who are better off should pay more in taxes. Horizontal equity means that two individuals in similar circumstances should pay similar amounts of tax. The concept of horizontal equity provides the rationale for the DTC. Because of their condition, persons with disabilities incur additional expenses that do not contribute to consumption enjoyment and that effectively reduce their disposable income. Without special recognition, however, their tax bill would be the same as a person with identical income who did not face these additional costs. By allowing an income tax credit for additional expenses that do not contribute to consumption enjoyment, the DTC establishes greater horizontal equity between people with and without disabilities.

[10] Income tax interpretation bulletin IT-513R, published by the Canada Revenue Agency, notes that there is no specific definition for the term "mental or physical infirmity," and therefore the term "takes its ordinary meaning." This interpretation bulletin also notes that a temporary illness is not classified as an infirmity.

Disability gives rise to different types of additional expenses. Some of the extra costs of disability are for items, such as wheelchairs and full-time attendant care, that are only needed by persons with disabilities. All of the money spent on these items can be considered extra costs of disability. These expenses are relatively easy to document and are generally recognized by the tax system, notably under the METC.

Other aspects of the extra costs of disability, however, are of a different nature. Individuals with disabilities also spend higher than average amounts on everyday goods and services, such as utilities, housing, clothing, household goods and transportation. For example, someone with a disability may spend more on utilities because they have medical devices that require electricity, or because reduced mobility makes them more sensitive to temperature and leads to higher heating bills.

These additional costs generally represent out-of-pocket expenses for persons with disabilities but are not recognized by the METC. This is because, in general, there is no way for someone with a disability to quantify all of these incremental costs and include the total on their METC claim. To improve fairness, therefore, the tax system needs a measure that provides general recognition for the extra expenses of everyday living incurred by Canadians with severe and prolonged disabilities. This is the DTC's policy role.

Canada is not alone in trying to ensure that the tax system treats persons with disabilities fairly. Some countries, including the United States, Australia and France, also offer tax measures that recognize the negative impact of additional disability expenses on the ability to pay tax. Other countries, such as the United Kingdom, offer no general tax measure for persons with disabilities. In the United Kingdom, however, persons with disabilities may receive some help with their extra costs through a direct non-taxable benefit, so there is less of a need for a tax credit that serves this purpose.

4. Is the DTC Reaching Its Target Population?

Assessing whether the DTC is reaching its target population is an important part of an evaluation of its effectiveness. It is possible to generate estimates of the DTC-eligible population using Statistics Canada surveys that ask Canadians about their activity limitations. These surveys include data on income, which can be used to determine how many of these eligible individuals, together with their supporting families, can make use of the credit. These estimates of the potential DTC recipient population can then be compared with the number of DTC recipients indicated by tax return data. It is not possible, however, to determine on an individual level whether a given person with a DTC-eligible activity limitation also reports receiving the DTC, and vice versa. The best that can be done is to compare survey estimates of the DTC-eligible population with the actual number of DTC claims at an aggregate level.

Estimating the DTC-Eligible Population

The first step is to produce an independent estimate of *how many Canadians, regardless* of their income, have severe and prolonged activity limitations that make them eligible for the DTC.[11] Statistics Canada has a number of surveys that ask individuals about different types of activity limitations. The first survey used in this analysis, the 2001 Participation and Activity Limitation Survey (PALS), is a survey of Canadians with disabilities.

All of the DTC-eligible population cannot, however, be captured using only PALS since that survey interviews only Canadians with disabilities living in private households. Some individuals with severe and prolonged disabilities live in nursing homes, group homes for persons with disabilities and other types of health institutions. If these individuals are excluded from the estimates, the size of the DTC-eligible population will be underestimated, and probably by a significant amount. As it turns out, Statistics Canada has another survey, the 1996–1997 National Population Health Survey (NPHS), which asks individuals living in health institutions about different types of activity limitations.[12] Since these two surveys cover mutually exclusive subpopulations and they both ask questions about activity limitations, they can be combined to produce an overall estimate for the DTC-eligible population.[13]

The match between the survey questions and the DTC eligibility criteria is imperfect. For a given activity limitation, the choice is often between one set of survey responses that may fail to capture everyone eligible for the DTC and another set of responses that may include some individuals who should not be considered eligible. To take account of this uncertainty, two estimates, one low and one high, are generated for each activity limitation, and by extension for the overall count. The underlying DTC-eligible population should be interpreted as lying somewhere between these low and high estimates.

Table 6
Estimates of the DTC-Eligible Population, 2001

	Low	High
DTC-eligible population in households (PALS)	353,000	559,000
DTC-eligible population in health institutions (NPHS)	133,000	166,000
Adjustment for missing activity limitations	12,000	20,000
Total	498,000	745,000

Note: Numbers rounded to nearest thousand.

[11] Since these survey estimates will be compared with 2001 tax return data, the DTC eligibility criteria in effect in 2001 are used as the basis for comparison.

[12] The 1996–1997 NPHS Health Institutions Survey is the most recent survey of this population that provides a representative cross-section.

[13] The DTC certification form considers an activity limitation to be prolonged if it lasts for at least one year. PALS, however, asks individuals about activity limitations that have lasted, or that are expected to last, six months or more. The NPHS does not specify an amount of time when asking about activity limitations, but rather refers to "a person's usual abilities." It is possible, then, that the estimates of the DTC-eligible population derived from the survey data are too high, since the surveys consider a somewhat shorter timeframe than is used to determine DTC eligibility.

Table 6 presents the estimates of the DTC-eligible population. For individuals living in private households, the low estimate of the DTC-eligible population is 353,000, and the high estimate is 559,000. The NPHS indicates that there are many DTC-eligible individuals living in health institutions. For this group, the low estimate is 133,000 and the high estimate is 166,000.[14]

Both the PALS and NPHS surveys have questions on most, but not all, of the activity limitations covered by the DTC. Neither survey has direct questions on eliminating bodily waste or life-sustaining therapy. The estimates therefore do not include individuals who would qualify for the DTC solely under one of these criteria (although those who also experience one of the activity limitations captured by the survey would already be in the count). Consequently, it is necessary to adjust the estimates of the DTC-eligible population for these missing activity limitations.

To adjust the estimates of the DTC-eligible population, it is possible to use tax return data, which provides some information on the types of activity limitations experienced by individuals claiming the DTC. In 2001 between 2.3 and 2.7 per cent of individuals who claimed the DTC listed eliminating bodily waste and life-sustaining therapy as their only activity limitations. Assuming that the same ratios apply to the survey estimates, it follows that the estimates of the DTC-eligible population should be adjusted by 12,000 to 20,000.

Combining the two sets of estimates and adding an adjustment factor to account for missing activity limitations yields overall estimates of the DTC-eligible population that range between 498,000 and 745,000. The actual number of DTC-eligible individuals is likely somewhere between these two numbers.

Estimating the Potential DTC Recipient Population

Since the DTC is an ability to pay tax measure, an estimate of the size of the DTC recipient population needs to take account of who can make use of the credit. More specifically, for an individual with a severe and prolonged disability to be a DTC recipient, they need to be in a position where they would be paying tax or have a family member in a position to benefit from a transfer of the credit.

The first step in estimating the DTC recipient population is to determine how many DTC-eligible individuals have enough income to make use of the credit directly. Both PALS and the NPHS include information on the individual's total income. Ideally, however, there would be data available on the individual's taxable income, since some forms of income, such as social assistance and the Guaranteed Income Supplement, are not taxable. By making adjustments for non-taxable components of income and taking account of basic personal credits that can be claimed, it is possible to use these data sets

[14] Since the NPHS Health Institutions Survey was conducted in 1996-1997, the estimates are adjusted for population growth between this period and 2001. Since the large majority of individuals in health institutions are senior citizens, the adjustment factor used is based on growth in the 65+ population.

to estimate the number of taxable DTC-eligible individuals.[15] As Table 7 shows, the low estimate of the number of taxable DTC-eligible individuals is 214,000 and the high estimate is 331,000.

Table 7
Estimates of the Potential DTC Recipient Population, 2001

	Low	High
DTC-eligible population (from Table 6)	498,000	745,000
DTC-eligible individuals who are taxable	214,000	331,000
Transfers (assuming 0.43 ratio of transfers to taxable individuals)	92,000	142,000
Total DTC recipient population	306,000	473,000

Note: Numbers rounded to nearest thousand.

The second step in this estimation process is to determine how many DTC-eligible individuals who cannot use the DTC themselves can transfer the credit to a family member who is taxable. Neither data set, however, includes enough information to permit a precise estimate for the number of transfers. On the one hand, PALS includes a variable on household income, but no information on family members living outside the household. On the other hand, the NPHS provides no information on the income of other family members.

Since these surveys do not include any direct information on transfers, the next best option is to study tax return data to learn about the ratio of transfers to taxable DTC recipients. In 2001, out of the claims made by or for 400,000 DTC-eligible individuals, 280,000 were claims directly made by taxable individuals (or taxable parents), and 120,000 were for transfers from non-taxable adults with disabilities. This translates into a ratio of 0.43 transfers for each taxable individual. It seems reasonable to assume that the same ratio of transfers to taxable individuals holds for the survey data as well. This assumption would yield estimates of the number of DTC transfers that range between 92,000 (low) and 142,000 (high).

Combining the estimates of the number of taxable DTC-eligible individuals and the number of transfers produces measures of the potential DTC recipient population. As Table 7 indicates, the estimates of the DTC recipient population range between 306,000 and 473,000.

[15] For individuals under 65, $10,000 of total income is used as the threshold below which individuals are non-taxable and above which individuals are taxable. For individuals 65 or older who are eligible for the age credit, $15,000 of total income is used as the threshold for taxable status. An analysis of tax return data, which also includes information on taxable income, indicates that these thresholds work well. For children, data on parents' income are used. Technically speaking, virtually all DTC-eligible children transfer the credit to their parents or another family member, but these claims do not count as transfers in this discussion. The discussion of transfers that follows therefore pertains to DTC-eligible adults who can transfer the credit to a family member.

Comparison With the Number of DTC Recipients

The next step in this analysis is to turn to tax return data to determine the number of DTC recipients. In Section 2, it was estimated that in 2001, DTC claims were made by or on behalf of 400,000 individuals with severe and prolonged impairments. This estimate leaves out some potential DTC recipients who are better off forgoing the DTC and including all of their attendant care or nursing home expenses in their METC claim. Since these individuals are being counted in the analysis of survey data on activity limitations, they should be included in this comparison. While there is no direct information on how many potential DTC recipients choose this option, tax return data on METC claims suggest that the total number in this category is approximately 22,000.[16] The resulting estimate of the total number of DTC recipients, both actual and potential, in the 2001 tax year is therefore 422,000.

The number of DTC recipients falls well within the range of estimates of the DTC recipient population based on survey data. Sensitivity analysis indicates that even when reasonable alternative assumptions are chosen for the number of transfers, the independent estimates of the recipient population are consistent with the actual number of DTC claims. This comparison indicates that, on the whole, Canadians with severe and prolonged activity limitations are making use of the DTC. This does not rule out the possibility that some potential recipients are not receiving the credit, or that some recipients are not in fact eligible. The analysis, however, suggests that there is no overall problem with take-up of this measure.

5. The Challenge of Measuring the Extra Costs of Disability

To determine whether the DTC is achieving its stated policy purpose, it is necessary to assess whether the dollar amount of the credit ($6,486 in 2004) is appropriate. That is, on average, do DTC recipients incur approximately this amount in extra out-of-pocket costs for everyday items?

Estimating the additional everyday expenses of disability is extremely challenging. It is not simply a question of asking individuals with severe disabilities what they spend on, for example, wheelchairs or full-time attendants, and defining all of the money spent on these items as extra costs. Rather, it requires understanding the difference between what individuals with severe disabilities currently spend on everyday items, such as housing, and transportation, and what they would have spent on these items if they did not have a

[16] With detailed data from previous years on the composition of METC claims, it is possible to show how many individuals with net METC claims above $16,000 made these claims for attendant care or nursing home expenses (individuals with attendant care expenses below this amount would be better off claiming $10,000 of expenses under the METC and the DTC). Taking individuals who did not claim the DTC, it can be shown that 83 per cent of seniors with high METC claims and 20 per cent of those under 65 with high METC claims had attendant care or nursing home expenses. These percentages can be applied to the 2001 data on METC claims.

disability. For persons with disabilities to provide direct measures of these incremental costs, they would have to know the difference between what they currently spend on different items and what they would have spent in the absence of their condition.

The other alternative is to try to come up with indirect measures of the extra everyday costs of disability. To do this would require a data set with information on spending patterns for persons both with and without disabilities. This would make it possible to analyze whether persons with disabilities as a group spend more than those without disabilities, all else equal, in different categories. For example, such an analysis could examine whether individuals with disabilities spend more on household goods than others, taking account of other differences between the two groups. If they spend more on average on household goods, the difference in spending levels would be defined as an extra cost of disability. This approach would produce an estimate of the average level of the additional expenses of disability in a given category, and these extra costs could then be aggregated across different categories.

Even with such a data set, there would be challenges associated with measuring the extra expenses of disability. One unavoidable issue will be the heterogeneity of the population with a disability. Different types of disability often cause some individuals to spend more than average and others to spend less than average in a given category. For example, while some individuals with disabilities may spend more on transportation, others may be unable to leave their home and may therefore spend less on transportation. Persons who spend less than average in a given category because of their disability should not be counted, but there is no way to remove them from the calculation. As a result, persons with disabilities spending less than average would drag down the average for those with disabilities as a whole. As a result, indirect estimates of the extra expenses of disability would likely be understated to some extent, and it is impossible to say by how much.

The Limitations of Current Data Sources

At the present time, there is no existing Canadian data set that allows the estimation of the extra everyday costs of disability. One natural starting point is Statistics Canada's Survey of Household Spending, Canada's principal source of information on what families spend on different items. However, the Survey of Household Spending does not currently ask any questions that indicate who has a disability.

Another potential resource for examining disability expenses is Statistics Canada's 2001 Participation and Activity Limitation Survey (PALS), Canada's main source of information on disability. PALS asks individuals with disabilities about their out-of-pocket spending in six different categories:

- Prescription and non-prescription drugs
- Aids and specialized equipment
- Health care and social services
- Help received
- Transportation
- Home modifications

Most of the expenditure categories in PALS refer to expenses that can be claimed under the METC, whereas this evaluation requires an analysis of the extra everyday expenses of disability for which receipts cannot be supplied. The only categories that relate to the DTC are non-prescription drugs, occasional help (i.e. housekeeping) and transportation. There are no questions in PALS about additional expenses for regular housing payments, utilities, clothing or household products. Consequently, using PALS in its current form would yield an underestimate of the extra everyday costs of disability.

Steps Being Taken to Develop Better Data

Since there is no appropriate data set, it is not currently possible to begin to develop a good estimate for how much DTC recipients incur in extra everyday costs. Given the importance of understanding the extra costs of disability, discussions are underway with Statistics Canada to develop better data.

One option being considered is adding questions on disability to the Survey of Household Spending. It may also be possible to modify the next version of PALS, currently scheduled for 2006, to try to measure the extra everyday costs associated with disability.

The discussion above suggests that no data set, even with modifications, will provide a complete measure of the extra everyday costs of disability.

6. Conclusion

The DTC is one of many measures that contribute to tax fairness for persons with disabilities. These measures provide tax relief for specific disability-related expenses (e.g. the METC) and for individuals caring for family members with disabilities. The unique role of the DTC is to provide tax relief for the additional everyday expenses incurred by individuals with severe and prolonged impairments and their supporting families. These expenses cannot be documented for tax purposes, so there is a need for a measure that provides general recognition of the negative impact of these extra everyday costs on the ability to pay tax.

This report shows that, based on existing eligibility criteria, the DTC seems to be reaching its target population. Independent estimates of the DTC recipient population, based on Statistics Canada survey data on activity limitations, are consistent with tax return data on the number of DTC recipients.

Finally, given the difficulty of quantifying the extra everyday costs of disability with current data, it is not possible to determine whether the DTC dollar amount is set at the right level. Steps are being taken to try to develop better data on the extra everyday costs of disability.

ANNEX
GOVERNMENT OF CANADA TAX MEASURES THAT BENEFIT PERSONS WITH DISABILITIES

Summary of Measures

Personal Income Tax

Tax relief for persons with disabilities and those who care for them

- Disability tax credit
- Disability supports deduction (proposed in the 2004 budget)
- Caregiver credit
- Infirm dependant credit

Benefits delivered through the tax system

- Refundable medical expense supplement
- Child Disability Benefit

Measures with special benefits for persons with disabilities

- Medical expense tax credit
- Eligible dependant credit
- Child care expense deduction
- Education credit
- Lifelong Learning Plan
- RRSP/RRIF rollover
- Registered education savings plans
- Home Buyers' Plan

Corporate Income Tax

- Expensing of capital expenses incurred to adapt buildings

Customs Tariff

- Duty-free entry of disability-related goods

Goods and Services Tax

- Special treatment of goods and services used by persons with disabilities

Excise Tax on Gasoline

- Refund for persons with a mobility impairment

Personal Income Tax

Tax Relief for Persons With Disabilities and Those Who Care for Them

Disability Supports Deduction

Proposed in the 2004 budget, this measure replaces the attendant care deduction. Under the attendant care deduction, taxpayers eligible for the DTC who required attendant care in order to earn business or employment income or, after 2000, to attend a designated educational institution or a secondary school were able to deduct the cost of that care. The proposed disability supports deduction will recognize attendant care as well as other disability supports expenses incurred for education or employment purposes, unless they have been reimbursed by a non-taxable payment (e.g. from an insurance company). Individuals will not have to be eligible for the DTC in order to claim the deduction.

For those earning employment or business income, the disability supports deduction will be limited to the lesser of:

- the amounts paid for eligible expenses; and
- the taxpayer's earned income.

For those attending school, the deduction will be limited to the lesser of:

- the amounts paid for eligible expenses; and
- the taxpayer's earned income plus the least of:
  - the taxpayer's non-employment income net of other deductions (i.e. the difference between the taxpayer's net income without taking the proposed disability supports deduction into account and the taxpayer's earned income);
  - $375 times the number of weeks in school; and
  - $15,000.

In other words, the deduction will generally be limited to the lesser of the amounts paid for eligible expenses and the taxpayer's earned income, which includes wages, self-employment income, and scholarships.

For students, the deduction will be limited to the lesser of the amounts paid for eligible expenses and the student's earned income plus an additional amount equal to the lesser of $375 times the number of weeks in school (up to a maximum of 40 weeks) and the student's other income net of other deductions.

The limit for students allows those who pay for disability supports in order to attend school with income other than earnings or scholarships to benefit from the deduction.

The effect of the new deduction will be that no income tax will be payable on income (including government assistance) used to pay for these expenses, and that this income will not be used in determining the value of income-tested benefits.

Caregiver Credit

The caregiver credit, introduced in 1998, recognizes that people who support certain adult relatives in their own home often incur expenses that reduce their ability to pay income tax. Eligible relatives include infirm dependent relatives who are 18 or older, and any parent or grandparent 65 years of age or over (regardless of infirmity).[17] For 2004 the maximum credit is $605 (16 per cent of $3,784). The credit is reduced when the dependant's net income exceeds $12,921 and is fully phased out when the dependant's net income reaches $16,705.[18]

Infirm Dependant Credit

The infirm dependant credit recognizes that individuals providing support to an infirm adult relative who lives in a separate residence may incur expenses that reduce their ability to pay income tax. This non-refundable measure applies to the same infirm adult relatives as the caregiver credit and generally provides the same amount of tax relief (up to $605, or 16 per cent of $3,784). The infirm dependant credit, however, is phased out at lower income levels; it is reduced when the dependant's net income exceeds $5,386, and is fully phased out when this net income reaches $9,152.

Benefits Delivered Through the Tax System

Refundable Medical Expense Supplement

Introduced in 1997, the refundable medical expense supplement recognizes that the loss of subsidies for disability-related supports under provincial social assistance for working adults with low incomes and above-average medical expenses can act as a barrier to participation in the labour force. This refundable tax credit supplements relief provided through the medical expense tax credit. Consequently, persons who claim the medical expense tax credit may also be able to claim this supplement, and any disability-related expenses claimed as medical expenses also qualify for the supplement.

To be eligible for the supplement, the person's net income from employment[19] must exceed $2,809. For 2004 the maximum supplement is 25 per cent of the allowable portion of expenses that can be claimed under the medical expense tax credit and 25 per cent of the amount claimed under the disability supports deduction announced in the March 2004 budget, up to a limit of $562. To target relief to working adults with low incomes, the supplement is reduced by 5 per cent of net family income in excess of $21,301. The supplement is refundable to the extent that the taxpayer's total income tax payable is less than the amount of the supplement. The supplement is fully indexed to inflation.

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[17] For the purposes of the caregiver credit, an infirm dependant relative could be someone's (or their spouse or common-law partner's) parent, grandparent, brother, sister, aunt, uncle, niece or nephew.

[18] The credit amounts and income thresholds for these three credits are fully indexed to inflation.

[19] The sum of employment income, net of deductions for registered pension plans, union dues and other employment expenses, plus net self-employment income.

Child Disability Benefit

Introduced in 2003, the Child Disability Benefit (CDB), a supplement to the federal Canada Child Tax Benefit, assists low- and modest-income families with the extra expenses associated with the care of children who are eligible for the DTC.

The maximum benefit for July 2004 to June 2005 is $1,653 per child with a disability under 18 years of age. The full CDB is provided for each eligible child to families having a net income below the amount at which the National Child Benefit supplement is fully phased out. For a family with one child with a disability, the maximum benefit is provided to families with net incomes of less than $35,000. These thresholds are higher for families with more DTC-eligible children. The CDB is reduced as net family income exceeds the family's threshold. The CDB amount and income thresholds at which benefits begin to be reduced are indexed to inflation.

Measures With Special Benefits for Persons With Disabilities

Medical Expense Tax Credit

The medical expense tax credit (METC) is a non-refundable credit that recognizes the effect of above-average medical expenses on an individual's ability to pay income tax. For 2004 the credit equals 16 per cent of qualifying medical expenses in excess of a net income threshold, which is the lesser of $1,813 or 3 per cent of net income (the $1,813 threshold is fully indexed to inflation). A person may claim medical expenses incurred by themselves, their spouse or their minor children. Taxpayers are also able to claim qualifying medical expenses paid on behalf of other dependent relatives that are in excess of the relative's net income threshold, subject to a maximum claim of $5,000.[20]

The list of eligible METC expenses is quite broad and is regularly reviewed and expanded in light of new technologies and developments. In particular, there have been a substantial number of disability-related expenses added to the list of eligible METC expenses in recent years.

[20] These particular arrangements for claiming the METC on behalf of dependants were proposed in the 2004 budget.

Recent Additions of Disability-Related Expenses to List of Eligible METC Expenses

1997

- 50 per cent of cost, up to $1,000, of air conditioner necessary to help individual cope with severe chronic ailment, disease or disorder
- 20 per cent of cost, up to $5,000, of van adapted for transportation of individual in wheelchair
- Sign language interpreter fees
- Expenses incurred during move to accessible housing
- Altering driveway to facilitate access to bus (for individuals with severe and prolonged mobility impairment)
- An increase in the part-time attendant care limit from $5,000 to $10,000.

1998

- Training expenses for caregivers

1999

- Care and supervision of persons with severe and prolonged impairments living in group home
- Therapy for persons with severe and prolonged impairments
- Tutoring for persons with learning disabilities (or other mental impairments)

2000

- Reasonable expenses of adapting a new home (i.e. during construction of the home) to the needs of a person with a disability

2003

- Real-time captioning services for persons with a hearing or speaking impairment
- Note-taking services for persons with a mental or physical impairment
- Voice-recognition software for individuals with a physical impairment

Eligible Dependant Credit

If someone who does not have a spouse is caring for an infirm adult relative in their own home, they may be able to claim the eligible dependant credit. It is not possible to claim the full amount of both this credit and the caregiver credit. The eligible dependant credit has a maximum value of $1,088 (16 per cent of $6,803), which is higher than the caregiver credit. However, it is phased out at lower income levels; the phase-out starts at $681 and ends at $7,484. In addition, the eligible dependant credit can only be claimed for infirm dependent children, grandchildren, brothers and sisters, as well as any child under 18 or any parent or grandparent.

Child Care Expense Deduction

Introduced in 1972, the child care expense deduction recognizes that taxpayers, their spouses or common-law partners often incur significant costs for child care to enable them to work or attend school. Child care expenses can act as a barrier to participation in the labour force, with their deductibility reducing this barrier. Furthermore, children with a disability or infirm children often require specialized care.

A supporting person may deduct the lesser of the expense limit, two-thirds of earned income,[21] or the actual amount of child care expenses incurred. If the child is eligible for the DTC, then the expense limit is $10,000 regardless of the child's age. For a child over 16 years of age who has a disability or is infirm, but does not qualify for the DTC, the expense limit is $4,000. Otherwise, the expense limits are $7,000 for a child less than 7 years of age and $4,000 for a child between 7 and 16 years of age.

Generally, only the supporting person with the lower net income can make a claim and this supporting person must also live with the child. In addition, if the child for whom the expenses are being claimed is dependent on either supporting person, but is not the child of either individual, then the child's net income must be less than the basic personal amount.

Since it reduces taxable income, the deduction may increase the disability amount that can be transferred to a spouse or to a relative who provides dependant care. However, it also reduces the amount of the disability supplement for a child with a disability less than 17 years of age.

Education Credit

Students can claim the education credit for each month of study at post-secondary institutions or in occupational training institutions that have been certified by the Minister of Human Resources and Skills Development. The credit is 16 per cent of $400 per month of full-time study, or $120 per month of part-time study. The credit is provided in recognition of non-tuition costs of post-secondary education, such as the costs of textbooks. Persons with disabilities, however, are often unable to attend a post-secondary institution on a full-time basis because of their disability.

Consequently, to improve their education opportunities, the full-time education credit is available to individuals who attend a qualifying post-secondary institution on a part-time basis and who are either eligible for the DTC or certified as being mentally or physically impaired for purposes of this credit.

[21] Earned income includes employment and self-employment income, scholarships, bursaries, fellowships, research grants, amounts received under a federal program to encourage employment and disability benefits under the Canada or Quebec Pension Plan.

Unused education amounts may be either carried forward for use by the student in a subsequent taxation year or, together with the tuition amount, transferred, to a maximum of $5,000, to the student's spouse, or to a parent or grandparent. However, amounts carried forward cannot be transferred at a later date.

Moreover, if even a portion of the education amount can be used by a student, then that portion must be used before any excess amount can be carried forward or transferred, and before the non-refundable medical expense tax credit can be used.

Lifelong Learning Plan

Introduced in 1999, the Lifelong Learning Plan allows any individual to make a tax-free withdrawal of up to $20,000 over four years from their registered retirement savings plan (RRSP) to help finance their education or training, or that of their spouse. Funds withdrawn for this purpose must be returned to the RRSP in equal annual instalments over no more than 10 years.

In general, this provision applies only to full-time students. However, people with disabilities are often unable to attend a post-secondary institution on a full-time basis because of their disability. Consequently, the Lifelong Learning Plan extends eligibility to part-time students who are either eligible for the DTC or certified as being mentally or physically impaired for purposes of the education credit.

RRSP/RRIF Rollover

When the annuitant under an RRSP or registered retirement income fund (RRIF) dies, the value of the RRSP or RRIF is generally included in computing the deceased's income for the year of death. However, preferential tax treatment on RRSP or RRIF distributions made after death is provided in certain cases, including where the proceeds are distributed to a child or grandchild who was financially dependent on the deceased annuitant by reason of physical or mental infirmity. In this case, the RRSP or RRIF proceeds may be transferred without tax to the RRSP of the child or may be used to purchase an immediate life annuity. For 2004 a child or grandchild is considered to be financially dependent if the child's income for the year preceding the year of death was below $14,035. This threshold is indexed to inflation.

Registered Education Savings Plans

Generally, a student has to be registered full-time at a qualifying post-secondary institution in order to receive a payment out of a registered education savings plan to further his/her post-secondary education. The full-time requirement is waived for students who qualify for the DTC and those who cannot reasonably be expected to be enrolled as a full-time student because of a certified mental or physical impairment.

Home Buyers' Plan

The Home Buyers' Plan allows individuals to make a tax-free withdrawal of up to $20,000 from their RRSP to purchase a home. Funds withdrawn for this purpose must be returned to the RRSP in equal annual instalments over no more than 15 years.

In general, the plan is targeted to first-time home buyers. However, since 1998, persons eligible for the DTC need not be first-time home buyers to benefit from the plan. In particular, these persons, their spouses and their relatives may draw funds from their RRSPs to help finance the purchase of a house that is better suited to the needs of the person with a disability. Furthermore, either the person with the disability, his/her spouse or relative of the person with the disability may own the house.

Corporate Income Tax

Expensing of Capital Expenses Incurred to Adapt Buildings

Certain capital expenses incurred to adapt a building to enable individuals who have a mobility impairment to gain access to the building or to be mobile within it can be deducted fully in the year the expense is incurred instead of being depreciated over time through the capital cost allowance system. Eligible capital expenditures include ramps, door openers and modifications to bathrooms, elevators and doorways. The same corporate tax treatment applies to expenses for certain disability-related devices or equipment (e.g., visual fire alarm indicators and listening devices for group meetings).

Customs Tariff

Duty-Free Entry of Disability-Related Goods

The *Customs Tariff* provides for duty-free entry of goods that are specifically designed to assist persons with disabilities in alleviating the effects of those disabilities, and articles and materials for use in such goods.

Goods and Services Tax

Special Treatment of Goods and Services Used by Persons With Disabilities

Many goods and services used by people with disabilities or infirmities are exempt from, or are zero-rated for purposes of, the goods and services tax/harmonized sales tax (GST/HST). Rebates of GST/HST are also available in certain cases.

- Exempt goods for which the GST/HST does not apply include most health care services, personal care and supervision programs provided in a business establishment, programs to provide prepared meals in the homes of people with disabilities, and recreational programs offered by public sector bodies.
- Zero-rated goods include prescription drugs as well as many medical devices and supplies and guide dogs.
- A rebate applies to modifications made to vehicles for persons with disabilities.

Excise Tax on Gasoline

Refund for Persons With a Mobility Impairment

A partial refund of 1.5¢ per litre is available for gasoline for the personal use by a person with a permanent mobility impairment who cannot safely use public transportation.

Taxation and Economic Efficiency: Results From a General Equilibrium Model

1. Introduction and Summary

The fundamental role of the tax system is to raise the revenue necessary to finance the programs and services provided by the government on behalf of citizens. While the provision of public services has clear benefits, taxes impose unavoidable costs on the economy through their effects on incentives to work, save and invest, and on a nation's ability to attract and retain skilled workers, entrepreneurs and investment capital. These impacts on economic efficiency vary by type of tax so governments can, in principle, adjust the mix of taxes to minimize the cost of financing a given level of government services.

Efficiency, of course, is not the only criteria according to which a tax system should be assessed. How the tax system affects the distribution of income in the economy is also an important consideration. In addition, the administrative burden imposed on government and the compliance costs imposed on taxpayers need to be taken into consideration.

This paper addresses the efficiency of the tax system and its various components. It provides estimates of the comparative long-run economic costs imposed by the principal taxes in Canada, as revealed by simulations with a model of the Canadian economy developed at the Department of Finance Canada. The estimates of the economic costs are a reflection of the effects that taxation has on behaviour. For example, labour taxation causes people to work less than they would in the absence of such taxation. Similarly, taxing investment causes people to invest less than they would otherwise.

The key finding of the analysis is that, in the current Canadian setting, taxes on saving and investment impose higher economic costs than taxes on wages and consumer spending. This is attributable to the impact on productivity and wages of capital accumulation effects that occur in response to changes in taxes on saving and investment. Taxes on wages and consumption also affect economic performance, but the effects are smaller because of the relatively low sensitivity of labour supply to changes in wages. While the estimates of the costs for specific taxes are sensitive to the assumptions made in constructing the model and to the channels of influence captured in it, the ranking of taxes by economic cost is robust and indeed consistent with other studies in the Canadian and international economic literature.

2. Principal Taxes in Canada

Canadian governments (federal, provincial, territorial and local) raised about $360 billion through taxation in the 2003–04 fiscal year, which is equivalent to about 30 per cent of Canada's gross domestic product or GDP (Table 1). This amount was split roughly equally between the federal government on the one hand and provincial/territorial/local governments on the other.

Table 1
The Tax Mix in Canada (Fiscal Year Ending March 31, 2004)

	% of tax revenues			
	Federal	Provincial/ territorial/ local	Total	% of GDP[2]
Personal income taxes[1]	**26.4**	**14.4**	**40.9**	**12.1**
On wage income	25.3	13.8	39.1	11.6
On investment income	1.2	0.6	1.8	0.5
Payroll taxes	**6.1**	**5.7**	**11.7**	**3.5**
General payroll taxes	0.0	2.4	2.4	0.7
Contributions to social security plans[3]	6.1	2.4	8.5	2.5
Health and drug insurance premiums	0.0	0.8	0.8	0.2
Property taxes[1]	**0.0**	**11.2**	**11.2**	**3.3**
Residential	0.0	6.5	6.5	1.9
Business	0.0	4.7	4.7	1.4
Corporate income taxes	**7.5**	**3.2**	**10.7**	**3.2**
Corporate capital taxes	**0.4**	**0.9**	**1.4**	**0.4**
Sales taxes[1]	**8.6**	**8.5**	**17.0**	**5.1**
Value-added taxes[4]	8.6	2.8	11.4	3.4
Retail sales taxes	0.0	5.6	5.6	1.7
On consumer spending	0.0	2.9	2.9	0.8
On business inputs	0.0	2.8	2.8	0.8
Excise taxes and customs duties	**3.4**	**3.6**	**7.1**	**2.1**
Total tax revenues (%)	**52.4**	**47.6**	**100.0**	**29.7**
Total tax revenues ($ billions)	**189.6**	**171.9**	**361.5**	
Total government revenues[5] ($ billions, %)	**203.5**	**254.8**	**458.3**	**37.6**

[1] Breakdown based on calculations by the Department of Finance.
[2] Based on 2003 GDP estimate in current dollars.
[3] Does not include Canada Pension Plan and Quebec Pension Plan.
[4] Consists of the goods and services tax/harmonized sales tax and the Québec sales tax.
[5] Non-tax revenues include user fees, net revenue from gaming activities, liquor profits and investment income. Excludes intergovernmental transfers.
Note: Numbers may not add due to rounding.
Source: Statistics Canada, tables 385-0001 and 380-0001.

Roughly 75 per cent of government tax revenue is raised through direct taxes on persons and corporations. Taxes on wage and salary income are the largest component, followed by payroll and property taxes. Corporate income taxes are next, accounting for just over 10 per cent of government tax revenues in Canada. Taxes on personal saving, or on investment income such as interest, dividends and capital gains, as well as corporate capital taxes, represent a small share of tax revenues.

Sales and other indirect taxes account for nearly 25 per cent of government tax revenues. In contrast to value-added taxes such as the goods and services tax/harmonized sales tax and the Québec sales tax, provincial retail sales taxes are imposed not only on consumer spending but also on certain intermediate materials and capital goods used by businesses.

3. General Equilibrium Models and Policy Analysis

Economic models provide a simplified representation of the market for a specific good or service, an industrial sector or the entire economy. They are used to evaluate the impact of changes in the economic environment, including government policies, on the market or economy being studied. Models that examine how long-run, or equilibrium, relationships are affected by changes in the economic environment are described as "general equilibrium" models.

General equilibrium models assume that capital and labour are fully employed at all times; the focus is therefore on how efficiently resources are being allocated in the economy rather than on how intensively they are being used. General equilibrium models use standard microeconomic theory to specify how the principal actors in the economy (i.e. consumers, firms and governments) respond to changes in relative prices and how their decisions interact. For example:

- The decision made by consumers about how much to save depends on the level of interest rates, which is in turn influenced by the investment decisions of firms. Ultimately, the interest rate adjusts to ensure that the total supply of savings equals the total demand for investment.
- Hiring decisions made by firms are influenced by the market wage rate, which in turn affects the number of people seeking work. In this case, the market wage adjusts to ensure that the demand for labour equals its supply.

General equilibrium models provide a unified and consistent framework within which several policy options can be evaluated and compared. The model results are dependent on estimates of the sensitivity of economic decisions to changes in relative prices. While these are empirically based, analysts may use different values of parameters to arrive at different quantitative results. Hence, general equilibrium models are more useful for the qualitative insights they provide and for ranking different policy choices than for the specific numerical results obtained.

The general equilibrium model used in this paper features a representative consumer and four representative corporations operating in four industries. The foreign sector consists of a single representative "agent" who owns a substantial portion of the domestic capital stock and who trades goods, services and financial capital with Canada. In the model, the consumer makes decisions about work, leisure, consumption and savings in a manner that maximizes his or her economic well-being, which is defined as a function of consumption and leisure time available. Economic well-being can therefore be thought of as the level of satisfaction over time associated with the amount of goods and services being consumed and the amount of leisure time available. Production decisions are made by

profit-maximizing firms operating in a competitive environment using one type of capital,[22] homogeneous labour and intermediate materials produced in Canada and abroad. Relative prices are the key determinant of the flow of goods and services between Canada and the rest of the world while the relative rates of return on investment determine the net flow of financial capital across borders.

The model examines the effects of altering the tax mix on four key decisions: the decision to consume or invest; the decision to invest at home or abroad (by both Canadians and foreigners); the labour-leisure decision; and the composition of consumption and investment in terms of domestically produced and imported commodities. While the demand and supply of labour and the economy's output are assumed to be always in balance, the stock of business capital and the stock of the consumer's financial assets take time to reach a new equilibrium value. As a result, the benefits of tax reductions that affect desired asset stocks take longer to be realized than tax reductions that affect consumption and labour supply decisions.

A thorough description of the structure of the model, data sources and calibration procedure is available in a background paper.[23]

4. Impacts of Taxation on Economic Efficiency

The estimates of the impact of various tax reductions on economic well-being are summarized in the chart below.[24] The simulations incorporate stylized tax measures that offset the revenue loss from the tax cut without creating any economic distortions. More specifically, the lost tax revenue is assumed to be recovered through "lump-sum" or head taxes, which have no effect on the incentives to work, save or invest. This assumption is used as a simplifying device, providing a neutral benchmark against which all policy options can be compared.

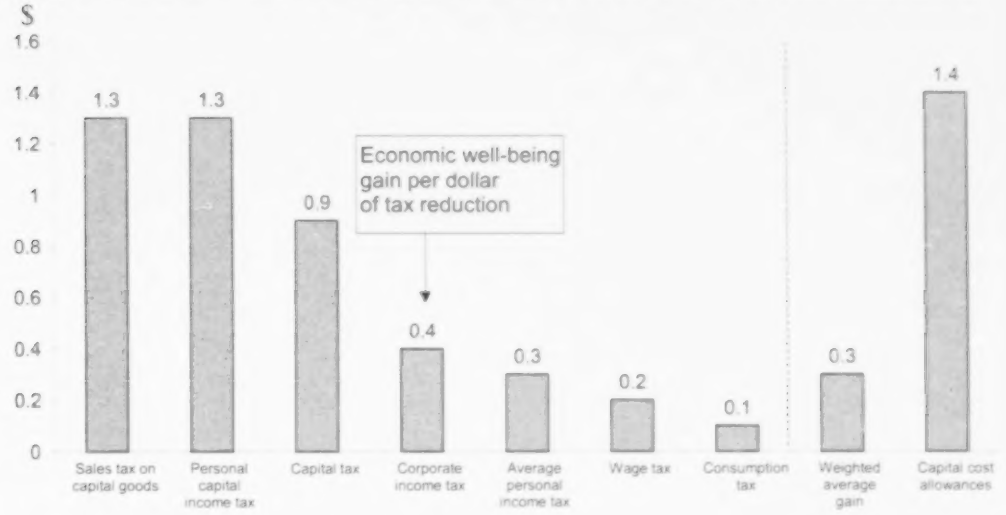
The full impacts of tax reductions take time to be realized and, as noted above, the time profile varies by type of tax. These differences can affect the estimated well-being gains from tax reductions. If two initiatives have the same long-run impact, the gain will be larger for the initiative that provides benefits earlier. In order to take these differences in the transition path into account, the change in economic well-being is measured on a discounted present-value basis. The figures in the chart are scaled to represent the economic well-being gain in dollars for a $1 reduction in tax revenue. For example, reducing personal capital income taxes by one dollar, and financing the revenue loss by a one-dollar lump-sum tax, would raise well-being measured on a discounted present-value basis by $1.30. This is the economic benefit to taxpayers and society of reducing the economic distortions that would otherwise result from this dollar of taxation.

[22] The useful life and the rate of capital consumption allowance of the single capital good do, however, vary by industry.

[23] Maximilian Baylor and Louis Beauséjour, "Taxation and Economic Efficiency: Results from a Canadian CGE Model," Department of Finance Canada working paper (forthcoming), www.fin.gc.ca/access/ecfisce.html.

[24] The simulated tax reductions represent small changes, not a fundamental restructuring of the tax system.

Long-Run Economic Well-Being Gain From Revenue-Neutral Tax Reductions*



* The revenue loss is assumed to be recovered through lump-sum taxation.

The estimates in the chart can be used to assess the efficiency effect of replacing the lost revenue with another tax. To continue with the previous example, if the lost tax revenue were replaced by a tax on consumer spending, there would still be a large net well-being gain since the economic benefit from reduced taxation of investment income is substantially higher than the economic cost associated with the taxation of consumer spending.

Before analyzing the results, it is worth explaining the two bars to the right of the dashed line in the chart. The first bar represents the weighted average gain in well-being for all taxes analyzed.[25] This calculation shows that a small, equal reduction in all taxes would raise well-being by 30 cents per dollar of revenue forgone. The second bar is the result for a simulated increase in capital cost allowance (CCA) on new capital only. Since the depreciation of capital is a cost borne by firms in the production process, the tax system allows the deduction of depreciation costs according to legislated CCA rates. This simulation is reported separately because increasing CCA is not a tax reduction per se but rather an increase in a deduction applicable against the corporate income tax.

As can be seen from the chart, the model suggests that reducing taxes on saving and investment produces larger gains than reducing taxes on wages or consumption. In particular, increasing CCA on new capital, cutting sales taxes on capital goods and cutting personal capital income taxes appear particularly potent.

[25] A reduction in property taxes is not included in this calculation.

Taxes on Saving and Investment Versus Labour and Consumption Taxes

The larger effect of taxes on saving and investment is attributable to capital accumulation effects. For example, reducing the tax on investment income raises the net-of-tax rate of return, which increases saving leading to a lower cost of capital to firms and higher investment. In turn, the higher capital stock boosts economic well-being by increasing productivity and, hence, wages.

In contrast, while reducing taxes on wages and consumption raises the real wage and improves economic performance by increasing hours worked, the benefits are small relative to tax cuts that affect saving and investment. This difference is largely determined by the relative size of two key model parameters: the sensitivity of labour supply to the wage rate and the sensitivity of investment to changes in the cost of capital. Estimates in the economic literature indicate that labour supply is less sensitive to changes in wages than investment is to the cost of capital.

The dynamics of the two types of tax cuts are also quite different. Reducing taxes on saving and investment initially leads to a fall in consumer spending as consumers find it beneficial, in light of the higher rate of return, to postpone consumption and to save. Eventually, of course, higher saving leads to a higher sustainable rate of consumption. In contrast, cutting wage and consumption taxes raises consumer spending immediately.

Reducing Taxes on New Investment

The model results suggest that reducing the sales tax on capital goods is a particularly effective way of promoting capital accumulation and hence well-being. The high cost-effectiveness reflects the fact that the tax cut is channelled entirely to new investment so there is no windfall gain to existing capital. Some of the tax cut will, however, accrue to foreigners, who undertake a substantial proportion of new investment in Canada.

Increasing CCA on new capital is a policy option whose mechanics are similar to those of reducing sales taxes on capital goods: only new capital is affected but there are also benefits to foreign investors. The results confirm the potential benefits of aligning CCA rates with economic lives where depreciation costs are not adequately covered. Such a policy change would reduce not only inter-temporal distortions but also inter-sectoral and inter-asset distortions.[26]

[26] These impacts are not captured in the model since, as indicated earlier, it contains only four industries and one representative capital good. See John Whalley, "Efficiency Considerations in Business Tax Reform," Working Paper 97-8, Technical Committee on Business Taxation, Ottawa for a discussion of the estimates of the efficiency gains from a more neutral corporate income tax system. Note that setting CCA rates in excess of economic lives would have negative effects because the tax system would distort the true economic cost of using a capital asset. In addition, "accelerated" CCA can encourage economically costly tax-planning activities.

Reducing Personal Capital Income Taxes

The model indicates that cutting personal capital income taxes (that is, taxes on interest, dividends and capital gains) provides benefits about as large as reducing the sales tax on capital goods or aligning CCA rates with economic lives. The key avenue of effect here is that the tax reduction increases the pool of Canadian savings, which reduces the cost of capital for Canadian firms. This result depends importantly on the assumption that most induced savings will be invested in Canada. Canadians invest about 80 per cent of their wealth in Canada, and it is assumed that this average "home bias" applies to the additional savings induced by the tax cut.[27]

Reducing Corporate Income Taxes

Reducing the statutory rate of corporate income tax promotes capital accumulation by increasing the after-tax return to capital. This option is, within the confines of the model, a less cost-effective way to improve well-being than reducing sales taxes on capital goods and personal taxes on capital income. The gap with sales taxes on capital goods largely reflects the fact that the statutory rate reduction applies to both old and new capital. There are two key factors that explain the gap with personal capital income tax reductions. First, some of the corporate income tax cut will accrue to foreigners, who own a substantial portion of the Canadian capital stock, while the personal capital income tax cut applies to Canadian residents only.

Second, the corporate income tax rate reductions interact with CCA and adjustment costs. When CCA exceeds economic depreciation, as it does on average in Canada, firms receive a tax benefit on new investment from CCA that is valued at the corporate tax rate. Reducing corporate taxes therefore lowers the value of the CCA tax benefit.[28] Since there is no interaction between CCA and personal capital income taxes, reducing them has a larger impact on the effective tax rate on new investment than a revenue-equivalent reduction in the corporate income tax rate.

This effect is reinforced when the adjustment costs that firms must go through when they make new investments are taken into consideration. Adjustment costs, modelled in the form of temporarily lower production as firms invest, reduce taxable income since they are, in effect, immediately expensed. A corporate tax rate reduction increases the after-tax cost of this "expense." This also lowers the benefit of the corporate income tax rate cut for new investment. There is no parallel effect with personal capital income taxes.

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[27] Theoretical arguments can be developed to support or refute this assumption, and empirical work does not provide firm guidance on the issue. The results are also affected by the assumption that the marginal source of investment funds for Canadian corporations is a taxable domestic resident. If the marginal source were a foreigner or a domestic tax-exempt resident, the cost-effectiveness of reductions in personal capital income taxes would be smaller. In this case, the existing empirical evidence points to the marginal supplier being a taxable resident.

[28] If CCA were on average less than economic depreciation, firms would be paying a tax penalty on new investment. In this case, a reduction in the statutory rate would result in a smaller penalty, which would favour investment in new capital and raise the cost-effectiveness of the corporate tax cut.

The model result does not take into consideration any tax-planning effects. In 2000 Canada's combined federal/provincial statutory rate was the second highest in the Group of Seven (G-7), giving multinational enterprises (MNEs) operating in Canada an incentive to shift taxable income to other jurisdictions. As a result of the rate reductions in the Five-Year Tax Reduction Plan announced in Budget 2000 and rate reductions by some provincial governments, Canada's statutory tax rate is now below the average U.S. (federal-state) rate and in the middle of rates in the G-7 countries. The tax cuts implemented since 2000 would be expected to deliver two benefits: additional investment in Canada and additional revenue since MNEs now have less of an incentive to shift taxable income out of Canada. The model results may therefore understate the impact on economic well-being for Canada of corporate tax reductions.

Capital Tax Reduction

Capital and corporate income tax reductions have different impacts on economic efficiency despite the fact that, in the absence of risk, they are equivalent ways of taxing income from capital. The difference arises because of the interaction between corporate income taxes and CCA and adjustment costs discussed above. Since there are no parallel effects with capital taxes, this interaction causes the corporate rate reduction to give less of the benefits to new capital than a revenue equivalent capital tax reduction.

Note, however, that the model does not capture the risk-shifting aspect of the capital tax. Unlike corporate income taxes, capital taxes must be paid even if the investment is not profitable, which makes them more distortionary. For example, capital taxes add to the losses incurred by businesses during economic downturns and reduce the cash flow of start-ups and expanding firms. In other words, because they are profit insensitive, capital taxes increase the risk of investing to business more than corporate income taxes, which share the risks between the firm and the government. In fact, profit insensitivity is the principal argument in favour of reducing capital taxes. Since this feature is not captured in the model, the results clearly understate the gains from capital tax reduction.

5. Sensitivity Analysis and Comparison With Other Studies

Sensitivity tests are implemented by performing the tax reduction simulations described in the section "Impacts of Taxation on Economic Efficiency" using alternative, yet equally plausible, values for important model parameters. This exercise reveals that the ranking of policy options is more or less unaffected, but that the point estimates do change substantially. This finding is consistent with results from other reviews of general equilibrium models.[29]

[29] See Kenneth Judd, "The Welfare Cost of Factor Taxation in a Perfect-Foresight Model," *Journal of Political Economy*, 1987, Vol. 95, No. 4 for a particularly convincing exposition.

Another issue that can affect results is model design. The choice of the theoretical framework that underpins the functioning of a model is of great importance since different frameworks can affect the results. In addition, because modellers tend to refine some areas and simplify others, different results can be obtained even within the confines of a given theoretical framework. A recent survey of the general equilibrium tax literature conducted at the Department of Finance explores the issue of result consistency across general equilibrium tax models.[30] The study reviews results from seven general equilibrium models (including the one used in this paper) and finds that they paint a fairly consistent picture. All but one of the seven studies reviewed find that taxes on capital are the most distortionary, followed by taxes on wages and then taxes on consumption. Furthermore, although only three studies examine the issue, measures targeted towards reducing taxes on new investment only are found to be highly effective. The magnitudes of the numerical results do, however, vary considerably by model and country.

6. Conclusion

This paper uses a general equilibrium model to simulate the impact of tax reductions. The simulations suggest that taxes on saving and investment impose the highest economic costs, followed by wage and then consumption taxes. Measures targeting new investment and personal capital income tax are found to be especially potent. The model results suggest that changes in the structure of taxation could improve economic performance.

It is important to remember a number of caveats in interpreting the results. Some of the channels through which tax policy affects the economy are not modelled. For example, tax-planning effects, which can have significant impacts in some circumstances, are not captured in the model: in this case, the results may underestimate the impact of corporate income tax reductions. Further, the model does not provide information about the effects that altering the tax mix might have on capital and labour quality. Finally, the estimates could be affected if the model were enriched by including more types of capital, more than one consumer and a more detailed modelling of the rest of the world.

Lastly, this paper focuses entirely on efficiency, which is but one of the criteria according to which any tax system should be assessed. Since the other criteria are also important to judgement on tax policy, the analysis provided herein offers only part of a larger picture.

[30] Maximilian Baylor, "Ranking Tax Distortions in Dynamic General Equilibrium Models," Department of Finance Canada working paper (forthcoming), www.fin.gc.ca/access/ecfisce.html.